TECHNICAL CORRECTIONS ACT OF 1982

HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

H.R. 6056

THE TECHNICAL CORRECTIONS ACT OF 1982

APRIL 27, 1982

Serial 97-59

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
95-736 O WASHINGTON : 1982

H781-31

COMMITTEE ON WAYS AND MEANS

DAN ROSTENKOWSKI, Illinois, *Chairman*

SAM M. GIBBONS, Florida
J. J. PICKLE, Texas
CHARLES B. RANGEL, New York
FORTNEY H. (PETE) STARK, California
JAMES R. JONES, Oklahoma
ANDY JACOBS, Jr., Indiana
HAROLD FORD, Tennessee
KEN HOLLAND, South Carolina
WILLIAM M. BRODHEAD, Michigan
ED JENKINS, Georgia
RICHARD A. GEPHARDT, Missouri
THOMAS J. DOWNEY, New York
CECIL (CEC) HEFTEL, Hawaii
WYCHE FOWLER, Jr., Georgia
FRANK J. GUARINI, New Jersey
JAMES M. SHANNON, Massachusetts
MARTY RUSSO, Illinois
DON J. PEASE, Ohio
KENT HANCE, Texas
ROBERT T. MATSUI, California
DON BAILEY, Pennsylvania
BERYL ANTHONY, Jr., Arkansas

BARBER B. CONABLE, Jr., New York
JOHN J. DUNCAN, Tennessee
BILL ARCHER, Texas
GUY VANDER JAGT, Michigan
PHILIP M. CRANE, Illinois
BILL FRENZEL, Minnesota
JAMES G. MARTIN, North Carolina
L. A. (SKIP) BAFALIS, Florida
RICHARD T. SCHULZE, Pennsylvania
BILL GRADISON, Ohio
JOHN H. ROUSSELOT, California
W. HENSON MOORE, Louisiana

John J. Salmon, *Chief Counsel*
Joseph K. Dowley, *Assistant Chief Counsel*
Robert J. Leonard, *Chief Tax Counsel*
A. L. Singleton, *Minority Chief of Staff*

CONTENTS

Page

Press release of Monday, April 19, 1982, announcing hearing 1

WITNESSES

Department of the Treasury, Hon. John E. Chapoton, Assistant Secretary for Tax Policy 2
American Electronics Association, Paul Oosterhuis 55
Battle, Frank V., Heinold Commodities Corp 52
California State Lands Commission, Robert Parkin 33
Computer & Business Equipment Manufacturers Association, Paul Oosterhuis 55
Daily Industries, Inc., Robert F. Long and Dennis I. Meyer 60
Heinold Commodities Corp., Frank V. Battle 52
Independent Petroleum Association of America, H. B. Scoggins, Jr 35
Jones, Peter T., Levi Strauss & Co 16
Kildee, Hon. Dale E., a Representative in Congress from the State of Michigan 13
Levi Strauss & Co., Peter T. Jones and Dennis I. Meyer 16
Long Beach, Calif., city of, Robert Parkin 33
Long, Robert F., Daily Industries, Inc 60
Lubick Donald C., Talisman Fund 52
Meyer, Dennis I.:
    Levi Strauss & Co 16
    Daily Industries, Inc 60
Mitchell Energy Corp., John E. Watson 43
Oosterhuis, Paul, American Electronics Association; Semiconductor Industry Association; Computer & Business Equipment Manufacturers Association; and Scientific Apparatus Makers Association 55
Parkin, Robert, California State Lands Commission, and city of Long Beach, Calif 33
Scientific Apparatus Makers Association, Paul Oosterhuis 55
Scoggins, H. B., Jr., Independent Petroleum Association of America 35
Semiconductor Industry Association, Paul Oosterhuis 55
Talisman Fund, Donald C. Lubick 52
Texas Independent Producers & Royalty Owners Association, Chester R. Upham, Jr 40
Upham, Chester R., Jr., Texas Independent Producers & Royalty Owners Association 40
Watson, John E., Mitchell Energy Corp 43

SUBMISSIONS FOR THE RECORD

American Association of Equipment Lessors, Michael Fleming, letter 64
American Gas Association, Michael Baly III, letter and statement 65
American Paper Institute, Inc., statement 67
American Petroleum Institute, statement 68
American Telephone & Telegraph Co., R. N. Flint, letter and attachment 71
Aminoil USA, Inc., Joe E. Day, statement 72
Baly, Michael, III, American Gas Association, letter and statement 65
Barr, James C., Credit Union National Association, Inc., letter 78
Bernstein, Rachelle B., Chamber of Commerce of the United States, statement 75
Chamber of Commerce of the United States, Rachelle B. Bernstein, statement 75
Chicago Board of Trade, Bradford L. Ferguson and Frederic W. Hickman, joint letter 76

Page
Chicago Mercantile Exchange, Bradford L. Ferguson and Frederic W. Hickman, joint letter 76
Cohn, Herbert B., Committee for Capital Formation Through Dividend Reinvestment, statement 77
Committee for Capital Formation Through Dividend Reinvestment, Herbert B. Cohn, statement 77
Credit Union National Association, Inc., James C. Barr, letter 78
Day, Joe E., Aminoil USA, Inc., statement 72
Ferguson, Bradford L., Chicago Board of Trade and Chicago Mercantile Exchange, joint letter 76
Fleming, Michael, American Association of Equipment Lessors, letter 64
Flint, R. N., American Telephone & Telegraph Co., letter and attachment 71
Gehrig, William L., Washington, D.C., statement 79
Glidden, Allan H., National Association of Real Estate Investment Trusts, Inc., letter and attachment 87
Hamon, Richard G., Winstead, McGuire, Sechrest & Minick, letter and attachment 99
Harris, David G., Arlington, Tex., statement 81
Henzke, Leonard J., Jr., Shriners Hospitals for Crippled Children, letter 95
Hickman, Frederic W., Chicago Board of Trade and Chicago Mercantile Exchange, joint letter 76
International Harvester Co., statement 83
Kinnebrew, Jack M., Dallas, Tex., statement 84
Murphy Oil Corp., W. Bayless Rowe, letter 86
National Association of Real Estate Investment Trusts, Inc., Allan H. Glidden, letter and attachment 87
National Cattlemen's Association, James L. Powell, statement 92
National Committee for Adoption, statement 94
Powell, James L., National Cattlemen's Association, statement 92
Rowe, W. Bayless, Murphy Oil Corp., letter 86
Schauwecker, Michael L., Southland Royalty Co., letter 98
Shriners Hospitals for Crippled Children, Leonard J. Henzke, Jr., letter 95
Southland Royalty Co., Michael L. Schauwecker, letter 96
Valero Energy Corp., James A. Walker, letter 98
Walker, James A., Valero Energy Corp., letter 98
Winstead, McGuire, Sechrest & Minick, Richard G. Hamon, letter and attachment 99

TECHNICAL CORRECTIONS ACT OF 1982

TUESDAY, APRIL 27, 1982

House of Representatives,
Committee on Ways and Means,
Washington, D.C.

The committee met at 2:10 p.m., pursuant to notice, in room 1100, Longworth House Office Building, Hon. Beryl Anthony presiding.

Mr. Anthony. The full committee will come to order.

The chairman of the committee, Mr. Rostenkowski, is unavoidably detained for a few minutes in the Steering and Policy Committee, so we will begin. I will read an opening statement the chairman had prepared on H.R. 6056, the Technical Corrections Act of 1982.

This afternoon the committee will receive testimony on H.R. 6056, the Technical Corrections Act of 1982. The bill was introduced by Mr. Rostenkowski and the Honorable Barber Conable to make technical corrections in the Economic Recovery Tax Act of 1981, the Crude Oil Windfall Profit Tax Act of 1980, and the Installment Sale Revision Act of 1980. The provisions of H.R. 6056 were inserted in the April 1, 1982, Congressional Record.

The chairman wishes to emphasize that those who wish to file a written statement for the printed record of these hearings must do so by the close of business on Friday, April 30, 1982. Without objection, the press release announcing this afternoon's hearing will be made a part of the record.

[The press release follows:]

[Press release No. 24, Monday, Apr. 19, 1982]

Hon. Dan Rostenkowski, Chairman, Committee on Ways and Means, Announces a 1-Day Public Hearing on H.R. 6056, the Technical Corrections Act of 1982

The Honorable Dan Rostenkowski, Chairman of the Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee on Ways and Means will hold a one-day public hearing on H.R. 6056, the Technical Corrections Act of 1982, beginning at 2:00 p.m. on Tuesday, April 27, 1982. The hearing will be held in the Main Committee Hearing Room, 1100 Longworth House Office Building.

H.R. 6056 was introduced on April 1, 1982, by Chairman Rostenkowski and the Honorable Barber Conable, Ranking Minority Member of the Committee. The bill corrects technical errors to the Economic Recovery Tax Act of 1981, the Crude Oil Windfall Profit Tax Act of 1980 and the Installment Sales Revision Act of 1980. A summary of the provisions of H.R. 6056 was inserted in the April 1, 1982, Congressional Record at page H1390.

It is anticipated that the Committee will receive testimony from Administration officials to be followed by testimony from Members of Congress and the general public who request to be heard.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD

Requests to be heard must be made by telephone to Ms. Harriett Lawler, telephone (202) 225-3627, by the close of business, Friday, April 23, 1982. The telephone request should be followed by a formal written request addressed to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

It is urged that persons and organizations having a common position make every effort to designate one spokesman to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearing. This process will afford more time for Committee members to interrogate witnesses.

The following is an outline of the procedure to be followed by organizations and individuals who either may want to appear and testify during this hearing or file a written statement for the printed record of the proceedings. All requests should contain the following information:

1. The name of the witness, his title, address, firm affiliation and/or organization he will represent (as well as a telephone number where he or his designated representative may be reached).
2. If appearing in an individual capacity, a list of any clients at whose request or in whose employ the witness appears.
3. A topical outline or summary of comments and recommendations.

Witnesses are required to submit 125 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of the hearing. Failure to comply with this rule may result in the witness not being allowed to testify.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

For those who wish to file a written statement for the printed record of the hearing, five copies (5) are required and must be received by the close of business, Friday, April 30, 1982. These statements should contain the information listed in #1-3 earlier in this press release. The statements should be delivered to John J. Salmon, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. An additional supply of statements for the printed record may be furnished for distribution to the press and public if supplied to the Committee office before the hearing begins.

Mr. ANTHONY. Our first witness is the Honorable John E. Chapoton, Assistant Secretary of the Treasury for tax policy. I welcome you to the committee and you may proceed with your testimony.

STATEMENT OF HON. JOHN E. CHAPOTON, ASSISTANT SECRETARY, TAX POLICY, DEPARTMENT OF THE TREASURY

Mr. CHAPOTON. Thank you, Mr. Chairman.

I have a brief statement. I will just go through it if I might.

I am pleased to be here this afternoon to present the Treasury Department's views on H.R. 6056, entitled the Technical Corrections Act of 1982. This bill makes technical revisions to the Economic Recovery Tax Act of 1981, the Crude Oil Windfall Profit Tax Act of 1980, and the Installment Sales Revision Act of 1980.

This committee well understands that technical corrections legislation is essential for all major tax legislation. Many important decisions and compromises are made late in the legislative process, thus requiring drafting of many complicated statutory provisions in a short period of time. Thus there is always a need for clarification and correction of drafting errors and oversights after there has been an opportunity to study the new statutory provisions over a longer period of time.

H.R. 6056 is based upon a technical review of the Economic Recovery Tax Act, the Crude Oil Windfall Profit Tax Act, and the Installment Sales Revision Act conducted by the staff of this committee and the joint committee staff, with the assistance of the Treasury Department staff. Numerous comments have been received from professional groups, individual tax practitioners, and other interested parties and were considered in this process.

The bill is intended to make only changes that are technical in nature, that is, changes necessary to clarify and conform the language of the Internal Revenue Code to the congressional intent in enacting these three statutory provisions. While it is sometimes difficult to distinguish between amendments that are technical and those that are substantive in nature, a sincere effort has been made in this bill to exclude changes not contemplated in the original legislation.

The Treasury Department strongly supports the enactment of H.R. 6056 at any early date. In some instances, prompt enactment of a technical correction is essential for the sound administration of the tax law. For example, under ERTA an individual is entitled to claim a 1.25-percent income tax credit in 1981 to give effect to the first stage of the 3-year across-the-board cut in marginal rates for individuals.

Under the literal terms of the statutory language, an individual could be entitled to use the credit, the 1.25-percent credit in 1981, to reduce the maximum rate on capital gains below 20 percent and the maximum rate on earned income below 50 percent. These would be 1981 changes entirely.

This was not intended by Congress and the 1981 tax return forms were drafted on the assumption that these maximum tax rates will be maintained. Nevertheless, prompt enactment of a technical amendment to the code is needed to make it clear that aggressive taxpayers will not be permitted to use this inadvertent technical error in the statute to obtain unintended tax benefits.

A similar problem is presented by the fact that ERTA eliminated from the code the tax preference for accelerated recovery deductions on real estate under the corporate minimum tax. The Treasury Department issued a statement in September of last year to the effect that this was an inadvertent drafting error which should be remedied by a technical corrections bill. We think prompt enactment of a technical corrections amendment is necessary to rectify this problem.

I would like to mention, Mr. Chairman, that the staff of the Joint Committee on Taxation has done an outstanding job in coordinating the technical review of these three acts. The various provisions of the Technical Corrections Act are well summarized in the joint committee staff pamphlet.

We would be happy to answer any questions you or other members of the committee might have about our position on the bill.

Chairman ROSTENKOWSKI. Thank you very much for your testimony.

Mr. Conable, do you have questions?

Mr. CONABLE. Mr. Secretary, are there any people taking advantage of that 1¼-percent tax reduction issue?

Mr. CHAPOTON. Mr. Conable, I understand that indeed there are some claims being made. Some advisers have advised that taxpayers should take advantage of that provision, yes.

Mr. CONABLE. But you have no doubt we can fix it retroactively?

Mr. CHAPOTON. No, I have no doubt that we can fix it retroactively.

Mr. CONABLE. Thank you.

Chairman ROSTENKOWSKI. Mr. Duncan, do you have questions?

Mr. DUNCAN. [Nods negatively.]

Chairman ROSTENKOWSKI. Mr. Hance, do you have questions?

Mr. HANCE. Yes, Mr. Chairman.

Mr. Chapoton, I am concerned with section 499(6)(b), the definition of crude oil. I would like for you to touch on that just briefly.

Mr. CHAPOTON. Which?

Mr. HANCE. The section of the bill addressing the definition of crude oil. In particular, the change in the treatment of condensates from the amount "recovered" to the amount "recoverable."

Mr. CHAPOTON. Mr. Hance, would you identify it. If it is on a committee pamphlet, I can find it more quickly.

Mr. HANCE. In the summary prepared by the Joint Committee staff, 499(6)(b). It would be page 19.

Mr. CHAPOTON. Yes, I have located it.

This is a question whether condensate is crude oil for purposes of the windfall profit tax, which is the basic change made here. There is also a more minor change dealing with whether the amount subject to tax is the amount recoverable or recovered. But the basic question is whether liquid condensate is crude oil.

That question has been raised from an early date. The position of the staff and the position of the Treasury Department all along has been that there is no doubt that the statute did intend to cover condensate. And this would clarify the law to that effect.

Mr. HANCE. I think there are several potential problems that will come up, and these are questions which I think you need to be looking at and the committee needs to be looking at concerning the proposed definition of crude oil. These would be considerations such as temperature and pressure standards. The amount that is recoverable will vary from field to field, from well to well.

Mr. CHAPOTON. You are going to the other part, not the question of whether it is crude oil but the amount recoverable.

Mr. HANCE. Right. And I think the other thing you have to look at is whether it is the amount actually recovered or the amount that can be potentially recovered. It looks like what you are going to do is make a major change by going from actual to potential recovery. What may be actually recovered in the Rocky Mountain States would certainly be different from the amount recovered in, say, south Texas.

And are you going to have one standard?

And the other thing I think you must look at is, will operators have to have some type of mechanical measuring device to measure at each and every well what there will be to recover?

Mr. CHAPOTON. Let me be candid. I am not up on that specific question. They ought to look at it. This is intended to be a technical correction to clarify the basic question, to make it clear on the basic question of the treatment of condensate. And I think we should address your question with the staff, and if it has gone too far we will look at it.

Mr. **Hance**. One thing I would like you to look at, and I can send you a list of questions—we are limited on time today, but I can send you a list of questions which, if you do not answer ahead of time, will create a real nightmare for every producer that has a gas well that has any condensate at all.

Because what may be recoverable at the wellhead may be two barrels, but down through the pipe additional condensate my drip out. It is much like a sponge. There are times when you have that sponge and you think you have everything, and a little later there may be something else.

And I think that unless we really answer these questions there will be tremendous administrative problems.

Mr. **Chapoton**. I remember well the problem you are addressing, the drip condensate later in the pipeline. We will look at it closely. And we would like to have the letter you mentioned.

Mr. **Hance**. To look at it closely, one thing that we have, Mr. Upham will be testifying a little later, and I think he points out very well that the variations could certainly lead to a regulatory nightmare. And I think that it is a realistic concern that the additional paperwork would cause more problems and more handicaps than any additional revenue or corrections you would hope to get out of this bill.

So I do hope you will look at those questions I submit to you very carefully.

Mr. **Chapoton**. I think it would be good if we could anticipate problems. I see the way this handles it is to leave a lot to Treasury regulations, so we might as well anticipate that now.

Mr. **Hance**. That happens frequently. Leaving it to Treasury or some other agency is generally not the best approach. I do not always know who will be over there.

I would like to get these problems tied down.

Mr. **Chapoton**. Believe me, Mr. Hance, we too would like to get it tied down. It can cause us no end of problems when we try to wrestle with it later.

Mr. **Hance**. I will submit those questions to you, then, and hopefully we can get that problem alleviated before this is passed.

Thank you, Mr. Chairman.

[The following was subsequently received:]

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

APR 29 1982

COMMITTEE ON
RECEIVED
APR 30 1982
WAYS AND MEANS

Dear Mr. Chairman:

During the course of my testimony before the Ways and Means Committee on H.R. 6056 on April 27 two questions were raised with regard to section 201(h)(2) of the bill which require additional amplification. Section 201(h)(2) provides that the term crude oil "includes condensates recoverable from natural gas (whether or not recovered before the natural gas is removed from the premises)." The first question deals with the issue of whether the Crude Oil Windfall Profit Tax Act of 1980 imposes a tax on condensate recovered from natural gas wells; that is, whether the change proposed by the bill is substantive rather than technical. The second question deals with the meaning of the term "recoverable" and the extent to which it empowers the Treasury to collect the tax at any point where liquids are recovered along a gas transmission system.

1. Definition of crude oil. Section 4996 of the Crude Oil Windfall Profit Tax Act states that the term "crude oil" has the meaning given to that term by the June 1979 energy regulations. Those regulations treat condensate from natural gas wells as crude oil subject to price controls. The conference report under the Act leaves no doubt that such condensate is to be taxed (see H. Rep. 96-817, 96th Cong., 2d Sess., p. 114). With respect to the incorporation of the energy regulations the conference report states:

> The conference agreement follows the House bill and the Senate amendment. Thus, the definition of crude oil for windfall profit tax purposes is fixed by the June 1979 energy regulations. Therefore, the term 'crude oil' means a mixture of hydrocarbons which exists as liquids in underground reservoirs and which remain liquid at atmospheric pressure after passing through surface separating facilities. The term also includes condensate recovered in associated or nonassociated production by mechanical separators located at any point at or before the inlet side of a gas processing plant, and natural gas liquid treated as crude oil under the June 1979 energy regulations. The term 'crude oil,' however, does not apply to synthetic petroleum such as oil production from shale or tar sands.

Indeed, it would have been inequitable for Congress to impose a windfall profit tax on amounts received by oil producers occasioned by the decontrol of the price of oil and not to impose such a tax on producers of gas well condensate that was similarly being decontrolled.

It has been asserted that in estimating the receipts from the windfall profit tax the congressional staffs did not include gas well condensate production in their calculations. From this it is argued that Congress did not intend to tax gas well condensate. Whether Congress taxed gas well condensate can only be established by an examination of the statute and the legislative history. Revenue assumptions, to the extent that they can be established, are irrelevant. Nevertheless, our investigation into the matter satisfies us that gas well condensate production was indeed included in Treasury and the Joint Tax Committee staffs' estimates of the anticipated receipts from the tax.

Accordingly, we believe that natural gas condensate is subject to the windfall profit tax and would be so treated even in the absence of this provision in the bill. The temporary Treasury regulations under section 4996 have so stated since the enactment of the tax in April 1980. We have no objection to the proposed technical amendment which states this affirmatively in the Windfall Profit Tax Act in addition to incorporating it through reference to the energy regulations.

2. Recoverable condensate. A question was also raised concerning the term "recoverable from natural gas" and whether it could be interpreted as subjecting to tax items which were never subject to the crude oil price regulations. The answer appears to us to be clear; that is, that under the windfall profit tax only crude oil from gas condensate that was subject to price controls under the June 1979 energy regulations is subject to tax. As the quotation from the conference report makes clear that means that the tax applies only to condensate recovered by mechanical separators located at any point at or before the inlet side of a gas processing plant and natural gas liquid treated as crude oil under the energy regulations.

The purpose of the "recoverable" language is only to make it clear that the condensate subject to tax need not have been collected on the premises and removed in liquid form in order to trigger the tax. In other words, gas condensate is also taxed upon removal from the lease although in a gaseous form. The amount of condensate so taxed is the amount which is recoverable at that point. This amount is to be determined in accordance with Treasury regulations which will describe how to calculate what is recoverable. However, that term does not, nor is it intended to, grant to the Treasury the authority to tax as crude oil gas that was not subject to the crude oil price controls.

As I indicated in my testimony, Treasury is prepared to work with the committee and with industry representatives to make certain that the method of calculating recoverable condensate is consistent with industry practices and is not unduly complex.

Sincerely,

John E Chapoton

John E. Chapoton
Assistant Secretary
(Tax Policy)

The Honorable
Daniel Rostenkowski
Chairman, Committee on Ways
and Means
U.S. House of Representatives
Washington, D.C. 20510

Mr. ANTHONY. Thank you.

Mr. Archer.

Mr. ARCHER. Mr. Secretary, just to follow up on what my colleague was questioning you about, do you know why the term "recoverable" was used relative to gas condensates instead of tracking the language in the DOE regulations under which this provision has been administered over the last year or so?

Mr. CHAPOTON. Mr. Archer, I do not know offhand. I know the problem. It is a tremendous administrative problem, since some of the condensate liquids will be recovered at a point later in time.

Mr. ARCHER. Is all you are trying to do here clarify whether condensates are taxable, inasmuch as some companies have alleged and protested that the law does not even cover condensates? Is that the purpose of this?

Mr. CHAPOTON. That is one of the purposes. I think we are all together on that purpose.

Mr. ARCHER. Well, we may not all be, but you are probably right that that is what will result.

Mr. CHAPOTON. But the other question is, what is the amount that will be subject to tax? And once you decide the first question, that is a difficult administrative question.

Mr. ARCHER. In line with what you just said, let me ask you this question. Under this proposed amendment, you don't intend to tax condensates that are not and cannot be efficiently recovered, do you?

I will give you an example. If a producer separates condensate from gas and sells the residue to a long-line gas transmission company, it is possible that some additional drips might fall out of the pipeline as a result of the movement of that gas which has already been separated. Now, the transmission company does not know where this drip comes from, they do not know what producers are to be charged with this, and the windfall profits tax must be charged back against the producer.

You say you are interested in cleaning up the administration, and yet by using the term "recoverable" you are compounding the problems, in this instance at least.

Do you intend to cover pipeline drip?

Mr. CHAPOTON. I think the way this is drafted it would give us regulatory authority to cover pipeline drip. I am not prepared to answer that yet.

Mr. ARCHER. What will the word "recoverable" mean, then, if it is going to simplify the administration?

Mr. CHAPOTON. Evidently the staff felt it was desirable to make it clear that the Treasury could tax that if it was administratively feasible. Now, we have not proposed anything that would deal with it that would make it feasible.

Mr. ARCHER. Do you not believe the law should clarify this, instead of just giving some sort of blanket authority to the Treasury to decide what should or should not be taxed?

Mr. CHAPOTON. Yes. I think we agree with your statement, and I think that the law is now clear that it would not be taxed after, I believe, after the separation inside of a plant.

Mr. ARCHER. So basically, what you are saying is the Treasury would work with us to establish a better terminology in the statute other than "recoverable," which is so broad.

Mr. CHAPOTON. I think "recoverable" is used in the sense it is used elsewhere in the statute, Mr. Archer. But we would not intend to go beyond the inlet side of the plant.

Mr. ARCHER. Would you intend to go beyond the DOE regulations which have been used as the basis for enforcing these provisions? Are there categories you want to reach that are not included in the DOE regs today? And if there are not, do we have to change this definition?

Let me move to one quick topic. That relates to the net profits interest. How do you understand they would apply to an overriding royalty measured by net profits? Because these kinds of arrangements are very common in the industry.

Mr. CHAPOTON. Yes, I know.

Mr. ARCHER. Where you have carried working interest and back interest standouts, where one working interest is appraised for developing another's interest. How would you treat those?

Mr. CHAPOTON. Excuse me, Mr. Archer. Let me go over that just a minute.

Mr. ARCHER. Under the net income limitation.

Mr. CHAPOTON. We would——

Mr. ARCHER. While you are looking, let me put it into the record that the proposed revisions do not seem to have any potential to increase the windfall profit tax unless the arbitrary shifting of revenue and expense increases the 90 percent of net income limitation. They do, however, have the potential of requiring tax payments from an owner who is not receiving oil revenue at the time he is required to pay the tax on it.

Now, surely you do not intend to bring that sort of result?

Mr. CHAPOTON. I have difficulty seeing how that would occur. The problem with the net profits interest is that there is a higher rate to apply to royalties than to an independent producer, and the net profits interest, the expenses come out later. This would—I mean, you do not know until you know the expenses what the actual net profits interest will be.

Therefore, to be safe you would have to pay the higher rate of tax on the entire interest burdened by the net profits interest and then claim a refund later. This change would take out the expenses first and then try to get at the net profits interest and the working interest after taking out those expenses.

I would have to go through it to see how it would result in a tax being imposed on one receiving no production income.

Mr. ARCHER. Well, the IRS has attacked these types of transactions under the concept that the actual assignment of a property interest for a limited time period should be ignored and treated as a loan arrangement. The practical results of it do not come out that way.

Mr. CHAPOTON. I am sorry. When you are talking about the net profits interest that is used in a production payment transaction, I think that is correct. But I believe that is consistent, is it not, with section 636 rules, which treat the production payment as a loan?

Mr. Archer. Well, the result, though, is that an owner who is not receiving oil revenues has got to pay the tax.

Mr. Chapoton. But he is receiving the benefit of the oil revenue, because it will discharge his obligation.

Mr. Archer. Well, it seems to me that you have an adverse economic result there that we should try to do something to mitigate.

I apppreciate the indulgence of the chairman. Thank you very much.

Mr. Anthony. Mr. Moore?

Mr. Moore. Thank you, Mr. Chairman.

Mr. Secretary, it is good to see you here again. We certainly appreciate hearing from you. I want to talk about the same thing my colleagues from Texas have spoken to, the definition of crude oil in page 19 of the Joint Committee report, the 13th item in the Technical Corrections Act.

I believe I have written to you about this in the past, not that I expect you to remember the letter. I am not willing to accept the fact that we intended the passage of the Windfall Profit Tax Act to include a tax on condensate.

I, sir, was on this committee when that was drawn. I offered the substitute that passed on the House floor and I was on the conference committee. And I do not remember us ever discussing the taxation of condensate. I do not think it appears anywhere—we have done some research on it—in the floor debate or anywhere in the committee report or in any of the comments of members.

And I wondered where you get the comment or the conclusion that you drew that it was intended to be taxed. I do not accept that.

Mr. Chapoton. Mr. Moore, I think liquid condensates have for most purposes been considered oil. In total dollar amount in the country, they are quite a major item, and I think when the Treasury Department reviewed the statute and the staff here reviewed the statute there was no exception for natural gas liquids condensate. And given its similarity in fact and in treatment under, I believe, the DOE rules, the position was taken that it was crude oil for purposes of the windfall profit tax.

We have taken that position consistently, and it seems to me that we ought to clarify that, and that is the purpose of this change. We certainly—if there is a serious question, then Congress ought to say the other way if it is not to be treated as crude oil, because we are taking the position that it is.

Mr. Moore. Well, the thing that confuses me is the fact that it goes back to a regulation issued by the Department of Energy as a definition of crude oil. I am not sure we accepted that. I could go back and do some research on that.

But the thing that was the telling blow and what we came out with in the ultimate tax was the fact that we were trying to raise a certain amount of money—$227 billion. We asked for projections from the Department of Energy and from the Joint Committee on what we had to tax to raise that amount of money. And they made those estimates and we passed a tax based upon that.

And then when the issue of condensate came up after the tax passed, this issue began to surface in the industry, I began to get inquiries. I passed them on to the Carter administration and subsequently I believe to the Reagan administration. I pointed out that at no time, according to my research, was the taxation of condensate a part of those revenue estimates.

In fact, I received a letter from Bernard M. Shapiro, who was then head of the Joint Committee on Taxation. The letter, dated July 28, 1980, confirmed that fact, that the computation of how much revenue would come in from taxing condensate was not part of the $227 billion figure and what we had to tax to raise that amount.

And I know for a fact that that was the limit we agreed on, and if we had something in there that was going to raise more money than that we would have altered the structure of the tax. We didn't mean to raise $227 billion-plus. It was supposed to be, as best we could pin it down from the state of the art, $227 billion.

My point is that since that was not in the figures within the industry, regardless of what the Department of Energy says, there is a difference between crude oil and condensate, particularly condensate from a gas well. We had no contemplation whatsoever in the Ways and Means Committee or on that conference committee to tax anything out of a gas well. We were supposed to be taxing crude oil and oil.

But what bemuses me is, we did not intend to go into gas wells. This was not a part of the revenue projections, and this really is not a technical correction. This is an expansion of what we intended to tax.

Mr. CHAPOTON. I am not familiar with Mr. Shapiro's letter. I was advised it was in our revenue estimates. But in any event, the $227.3 billion revenue target is a cutoff point. That is, when it is reached the tax ends. So we would not raise more money than that, I believe.

We will have to look back. I thought there was mention of this in the conference report on the Windfall Profit Tax Act. It certainly was the understanding at the Treasury Department, because we have been back over this question throughout, that we were talking about condensate, indeed condensate from a gas well specifically.

Mr. MOORE. According to his letter, he took that into account. He says:

> You are correct in noting that the crude oil estimates that the Department of Energy made available to the Congress during the consideration of the crude oil windfall profit tax apparently took into account crude oil condensate recovered from wells producing oil, but not condensate produced from natural gas wells.

We were sensitive to that, those of us on the committee trying to minimize what we felt was the destructive effect of that tax on natural gas and oil production, and we signed off on that and never would have gone along with that without reducing that $227 billion figure if we knew we were taxing gas wells.

And I for one was there and never intended this to be covered. And I have subsequently looked into it and have been told by the Joint Committee on Taxation's counsel that this in fact was not a part of the revenue estimates we had. Whether or not the Department issued regulations calling for something or not, I do not think this was in it.

Mr. **Chapoton**. I would like to look into the revenue estimate question again, Mr. Moore. Keep in mind, we are not talking about the total receipts. They are going to be capped anyway. What we are talking about is who bears the burden, and the question you are raising is whether condensate would bear a part of that burden. A positive answer to that question would not raise the total receipts for the windfall profit tax.

Mr. **Moore**. At the time we were determining it, it was not that way. Ultimately it wound up in the Senate version that way. But in the House version it was a different way. We were trying to figure out what was going to be taxed to raise that money.

And I wish you would look into it, because I do submit with all respect that this really is not a technical amendment, it is an expansion of what we intended to tax. Maybe this committee will vote to tax condensate out of a gas well. But I think it is not in the nature of a technical correction.

Thank you.

Mr. **Anthony**. Are there other questions from other members of the committee?

Mr. Hance.

Mr. **Hance**. Thank you, Mr. Chairman. I have one more question.

On page 20, you have a section on transfers. I am concerned that the term "necessary production equipment" may be a little vague, and I am inclined to think that some examples of specific equipment should probably be included, either in the legislative language or in the report language, in order to prevent any further problems.

The Joint Committee pamphlet refers to casing and pumps. I think you can go a little further than that. What other types of equipment should be included? That is a concern I would like you to look at, Mr. Secretary.

Mr. **Chapoton**. All right, we would be happy to.

Mr. **Hance**. Thank you, Mr. Chairman.

Mr. **Matsui** [presiding]. Are there any further questions?

[No response.]

Mr. **Matsui**. Thank you very much, Mr. Chapoton. We appreciate your testimony this afternoon.

Mr. **Chapoton**. Thank you, Mr. Chairman.

Mr. **Matsui**. At this time I would like to ask the gentleman from Michigan, Mr. Kildee, to testify before us.

STATEMENT OF HON. DALE E. KILDEE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. **Kildee**. Thank you, Mr. Chairman. I appreciate this opportunity to testify. I have submitted written testimony and for your convenience I will summarize that written testimony.

Mr. **Matsui**. Without objection, it will be entered into the record.

Mr. **Kildee**. Thank you, Mr. Chairman.

I am here to submit for committee consideration a proposal to correct a technical oversight in the statutory language of the 1981 tax bill. If left uncorrected, the oversight could delay or prevent construction of a theme park complex in economically troubled Flint, Mich.

The Autoworld Theme Park has been designed to salute the contribution that the automobile industry has made to American society. The architectural design envisages the rehabilitation of two existing structures and includes rides, exhibits, and educational materials which will be available to visitors. It also includes the new construction of a domed facility to house an extensive reconstruction of historic Flint.

The total financing of $60 million will be provided through a secured urban development action grant, various loans, municipal revenue bonds for land acquisition, foundation grants and loans, and approximately $7 million in investor capital.

The ability to attract investor capital in this amount is dependent upon the tax benefits to be derived from an investment in Autoworld. One specific phase of Autoworld that is expected to generate substantial tax benefits to investors is the rehabilitation of an existing historic structure which will serve as the center of the theme park's educational and museum activities.

The building involved is known as the Industrial Mutual Association Building, which is one of Flint's most historic buildings. The projected cost for the rehabilitation of the IMA building is estimated to be $9 million, upon which it was originally felt there could be a credit of 25 percent, equal to $2.25 million.

However, a technical problem has arisen in the drafting of the 1981 tax bill that appears to preclude the credit for rehabilitation of theme park structures. During consideration of the 1981 tax bill, Congress was persuaded that a shorter recovery period of 10 years should be assigned to theme park structures. At the same time, however, one of the requirements the tax bill imposed for obtaining the 25-percent rehabilitation of certified historic structures is that the expenditure be incurred in connection with a property that has a recovery period of 15 years.

The unfortunate and unintended consequence of the interplay between the 10-year recovery period assigned to theme park structures under the 1981 tax bill and the requirement that qualifying rehabilitation expenditures be incurred in connection with real property having a 15-year recovery period is that investing taxpayers are precluded from claiming the investment tax credit for rehabilitation of a theme park structure.

My proposal, which will be introduced shortly, will be cosponsored by three members of your committee, Representatives Gephardt, Brodhead, and Vander Jagt. It would permit a taxpayer to choose between a 10-year recovery period as provided by the 1981 tax bill or a 15-year recovery period as provided under old law.

If the taxpayer elects a 15-year recovery period for theme park structures, a rehabilitation tax credit could be taken as provided under current law. If the taxpayer elects to take the alternative 10-year recovery period, a rehabilitation tax credit would be prohibited as required by current law. Of course, no rehabilitation credit could be taken unless it involved eligible property.

The city of Flint, where many of my constituents reside, is suffering from one of the most severe economic crises in its history. Unemployment in Flint currently exceeds 25 percent, with no immediate relief in sight. Development and completion of Autoworld will serve as a needed impetus to the economy of Flint by creating not only jobs during the construction process, but also through the creation of a significant number of permanent jobs for local residents.

It is thus critical to Flint that the proposal which I offer be included in the technical corrections bill to be marked up by your committee. This will send the proper signal to investors that rehabilitation credits will in fact be available.

I respectfully urge the adoption of this proposal as an amendment to the technical corrections bill to be considered by the committee. Thank you very much for your attention.

[The prepared statement follows:]

STATEMENT OF HON. DALE E. KILDEE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. Chairman, I am here to submit for the consideration of this Committee a proposal to correct a technical oversight in the statutory language of the Economic Recovery Tax Act of 1981 (1981 Tax Bill) which if left uncorrected could delay or actually prevent construction of a theme and amusement park complex in the economically troubled community of Flint, Michigan. It is my intention that this proposal be offered as an amendment to the Technical Corrections bill to be considered very soon by this Committee.

For some time, plans have been underway to develop and construct a theme park complex in downtown Flint, Michigan, known as the Autoworld Educational Museum and Theme Park (Autoworld Complex), to salute the contribution that the automobile industry has made to American society in this century. The Autoworld Complex as proposed will offer to visitors a panoply of entertainment activities, historical attractions, and specialty shops. The architectural design envisages the rehabilitation and refurbishing of two existing structures, which will present rides, exhibits, and educational materials to visitors. It also calls for the new construction of a domed-facility to house an extensive reconstruction of historic Flint together with rides, exhibits, specialty shops, and a variety of restaurant and other entertainment facilities. The domed structure will be connected to the existing structures by a corridor in the form of a large model of an internal combustion engine through which visitors will pass. The total financing for the Autoworld Complex of $60 million will be provided through a variety of sources, including an Urban Development Action Grant, various loans, tax-exempt financing, foundation grants or loans, and approximately $7 million in investor capital.

However, the ability to attract investor capital in this amount is heavily dependent upon the tax benefits to be derived from an investment in the Autoworld Complex. One specific phase of the Autoworld Complex that is expected to generate substantial tax benefits to investors is the rehabilitation of an existing historic structure, which will serve as the center of the theme park's educational and museum activities. The building involved is known as the Industrial Mutual Association Building (IMA) which is one of urban Flint's most historic buildings. Application has been made to the proper authorities for certification of this building as a historic structure to be listed on the National Register.

The projected cost for rehabilitation of the IMA Building is estimated to be approximately $9 million upon which it was originally felt that there would be a credit of 25 percent equal to $2.25 million. However, a technical problem has arisen in the drafting of the 1981 Tax Bill that appears to preclude the credit for rehabilitation of theme park structures, such as the Autoworld Complex.

During consideration of the 1981 Tax Bill, Congress was persuaded that a shorter recovery period should be assigned to theme park structures. These structures experience more rapid deterioration caused by the heavy volume of visitors utilizing the facilities, than customarily is the case with other real estate, such as office buildings, shopping centers, and apartment projects. Accordingly, while granting real estate in general at 15-year recovery period, Congress included theme and amusement parks in the class to be assigned a 10-year recovery period. At the same time, however, one of the requirements that the 1981 Tax Bill imposed for obtaining the 25 percent credit for rehabilitation of certified historic structures is that the expenditure be incurred in connection with real property that has a recovery period of 15 years. See Section 48(g)(2)(A)(ii).

The unfortunate and unintended consequence of the interplay between the 10-year recovery period assigned to theme park structures under the 1981 Tax Bill and the requirement that qualifying rehabilitation expenditures be incurred in connection with real property having a 15-year recovery period is that investing taxpayers are precluded from claiming the investment tax credit for rehabilitation of a theme park structure.

My proposal, which will be introduced shortly, will be co-sponsored by three members of your Committee (Representatives Gephardt, Brodhead and Vander Jagt). It would permit a taxpayer to choose between a 10-year recovery period as provided by the 1981 Tax Bill or a 15-year recovery period as provided under old law. If the taxpayer elects a 15-year recovery period for theme park structures, a rehabilitation tax credit could be taken as provided under current law. If the taxpayer elects to take the alternative 10-year recovery period, a rehabilitation tax credit would be prohibited as required by current law. Of course, no rehabilitation credit can be taken unless it involves age-eligible property.

Mr. Chairman, the City of Flint, where many of my constituents reside, is suffering from one of the worst economic crises in its history. Unemployment in Flint currently exceeds 25 percent with no immediate relief in sight. Development and completion of the Autoworld Complex will serve as a needed shot in the arm to the economy of Flint by creating not only jobs during the construction process, but also through the creation of a significant number of permanent jobs for local residents whose services will be needed in order to accommodate tourists visiting the Autoworld Complex. However, financing of the Autoworld Complex is delicately balanced between various government and foundation grants and the ability to raise the necessary equity capital. Without the equity capital that is dependent upon the availability of the 25 percent rehabilitation credit for rehabilitation of historic structures, it is questionable that the Autoworld Complex will be completed. It is thus critical that the proposal which I offer be included in the Technical Corrections bill to be marked up by the Committee in order to send the proper signal to investors that the rehabilitation credit will in fact be available.

I respectfully urge the adoption of this proposal as an amendment to the Technical Corrections bill to be considered by the Committee.

Thank you for your attention.

Mr. MATSUI. Thank you very much, Mr. Kildee.

Do any members have questions of Mr. Kildee?

[No response.]

Mr. MATSUI. Thank you very much. We appreciate your testimony here today.

Mr. KILDEE. Thank you.

Mr. MATSUI. At this time we would like to call on Mr. Peter Jones, the senior executive vice president of Levi Strauss & Co. He will be accompanied by his counsel, Mr. Dennis Meyer.

STATEMENT OF PETER T. JONES, SENIOR VICE PRESIDENT, LEVI STRAUSS & CO., ACCOMPANIED BY DENNIS I. MEYER, COUNSEL

Mr. JONES. Mr. Chairman, thank you. If I may be permitted a second of nostalgia, I spent several consecutive months in executive session with this committee back in 1962 with my beloved boss, Luther Hodges, when we presented President Kennedy's Trade Expansion Act to this committee in open session and marked it up day after day, and I have not been back since and I am glad to be back.

Mr. MATSUI. Thank you. We welcome you back today.

Mr. JONES. Thank you very much. I appreciate very much the opportunity to be heard by the committee today with respect to a proposed technical correction or clarification to the recently enacted incentive stock option legislation.

One of the significant aspects of the incentive stock option legislation passed by Congress as part of the Economic Recovery Act of 1981 was the inclusion of a transitional rule which permits a company to elect incentive stock option, or ISO, treatment for nonqualified stock options granted to its employees on or after January 1, 1976.

In its temporary regulations relating to this transitional rule, however, the Treasury Department has taken the position that if ISO treatment is elected for a nonqualified option any pre-ERTA amendment to that option will be treated as a modification of the option under section 425(h) of the code and require the electing company to do one of two things—both of which, if you will pardon me, are ridiculous—either to rescind the particular amendment or increase the option price to an amount equal to the fair market value of the stock on the date of the amendment, in effect nullifying the benefit of the option.

As a consequence of this Treasury Department position, a substantial number of employees throughout the country will be denied the benefit intended by Congress when it adopted retroactive application of this new ISO legislation. And far more important to this committee, if you follow the Treasury interpretation, you will eliminate an important further incentive for businessmen to drive their companies forward for greater growth, investment, productivity, and employment.

BACKGROUND

Subsequent to the repeal by Congress in 1976 of the qualified stock option provisions, many companies continued to issue and utilize stock options as an employee incentive mechanism. These so-called "nonqualified" stock options, however, were not accorded the favorable tax treatment previously available to qualified stock options and were likewise not subject to the restrictions imposed upon qualified stock options. They therefore provided substantially less incentive for businessmen to drive their companies forward for greater growth, productivity, and employment.

You read constantly in the press today criticism of business not looking for the long run, looking only to the short run, not taking the risks of entrepreneurship. ISO's were designed to provide that incentive to the business community to invest more.

A very important restriction imposed on qualified stock options is contained in section 425(h) of the code. This generally provides that a modification to a qualified stock option—that is, an amendment to the option that gives the employee additional benefits under the option—will be treated as the issuance by the company of a new option. That means that an amendment to an option that gives the employee additional benefits under the option is treated as if the company issued a new option.

So, if a company sets an option price at *x* and makes amendments later on, under the Treasury interpretation you would have to set a new price for the option as though you were issuing it all over again, and that in effect nullifies the effect of the option in terms of the economy.

Under the qualified stock option rules, the option price had to be set at an amount at least equal to the fair market value of the stock on the date of the grant. Therefore, under Treasury's interpretation, section 425(h), by treating an option modification made prior to ERTA as the grant of a new stock option essentially required that the price be increased to the market value of the stock on the date of the modification.

As I said, doing this in many cases would wipe out all or most of the entire value and incentive of the option in terms of what it is supposed to do for the economy. However, since this section 425(h) repricing rule did not apply to nonqualified options, many companies, usually acting on the advice of employee benefit consultants, made various amendments to their nonqualified option plans with no awareness that such amendments would ever be subject to this repricing rule.

As a result of an IRS ruling in 1980, some very effective, popular and widely implemented amendments were applied to permit employees to exercise nonqualified options with previously acquired corporate stock in lieu of cash. But under the Treasury interpretation set forth in its temporary regulations, such a stock-for-stock amendment made prior to the enactment of ERTA will nevertheless be treated as a section 425(h) modification for purposes of the ISO "transitional rule."

Thus, under Treasury's interpretation in these regulations, in order to bring a nonqualified option within the ISO provisions the company must either rescind the amendment or increase the option price to an amount equal to the fair market value of the stock on the date of the amendment. Either alternative would substantially weaken the effectiveness and incentives of these options.

However, Treasury plans or attempts to characterize the alternative to either rescind or reprice as giving taxpayers a liberal amount of flexibility under the statute. My personal opinion is that Treasury is acting like bureaucrats all too often do in intervening, adding regulations where regulations are not called for, and going against the intent of Congress to make this provision retroactive. The Treasury interpretation would nullify congressional intent to apply the ISO on a retroactive basis.

In addition, Treasury failed to take into account the fact that prior to the issuance of the regulations numerous employees had already exercised an amended, nonqualified option and in these situations there is no remedial measure available under the temporary regulations, and consequently no possibility of ISO treatment.

STATEMENT OF POSITION

The Treasury Department's retroactive application of section 425(h) repricing is contrary to congressional intent. I think that this is the guts of our argument to this committee: Contrary to the congressional intent that previously issued nonqualified options be permitted to qualify for ISO treatment. In this connection, on November 5 of last year, Congressmen Frenzel and Jones, sponsors of the ISO provision, sent a letter to Treasury Secretary Chapoton stating, and I quote—and this is important:

> Between 1976 and 1980 companies which had stock option plans often made amendments to their plans which facilitated their use. Many of these amendments, such as allowing stock for stock exchanges and the use of stock appreciation rights, received the explicit—

And I repeat:

explicit approval of the Congress in the 1981 Act.

"In our judgment," say Congressmen Frenzel and Jones:

> The Congress did not intend that plans which made these amendments would be considered to have re-granted their options. We believe that the amendments were simply adjustments which were necessary to help maintain the original incentive value of the options. We therefore think that it would be a serious mistake—

And this is key language—

> And would go beyond the intent of Congress, for the Treasury to issue regulations which would consider such minor amendments to stock option plans as modifications resulting in the grant of a new option,

And having to reprice upward is my last addition.

At the outset, section 251(c)(2) of ERTA states that amendments made "within 1 year after date of enactment" of ERTA to allow a nonqualified option to qualify as an ISO shall not be treated as a section 425(h) repricing modification. Thus, it seems clear that Congress intended section 425(h) to apply only to amendments made after the enactment of ERTA and not, as Treasury is attempting to require, to any amendment made prior thereto.

In this regard, Assistant Secretary Chapoton just last month sent a letter to Representative Conable in response to Mr. Conable's letter of November 9, 1981. In this letter Mr. Chapoton attempted to present a technical defense of Treasury's position based upon the language of the statute and the conference report. A legal refutation of the position expressed in this letter is beyond the scope of my testimony today, you will be grateful to hear, but we will submit for the record a memorandum showing that the legal rationale expressed by Assistant Secretary Chapoton is, at best, strained and, we believe, provides no legal foundation for Treasury's position.

Furthermore, Treasury's retroactive application of section 425(h) violates simple principles of equity and fair play. The amendments made by companies to nonqualified options prior to the enactment of ERTA were made in good faith and, in the main, to furnish an IRS-sanctioned benefit to their employees. These companies had absolutely no realization that by making these amendments these same employees would be subsequently penalized under a future Treasury interpretation contrary to congressional intent—bureaucracy at its best.

The inequity of Treasury's position is further evidenced by the fact that employees of companies which did not amend their nonqualified options will suffer no adverse consequences while employees of those companies which amended their plans out of concern for employee welfare are placed at a severe disadvantage. Surely the latter class of employees should not be penalized as a result of the prudent action taken in the past by their employers.

Lastly, in addition to failing the fairness test, the Treasury's position cannot withstand technical scrutiny due to the patent inconsistency in its own regulations with respect to pre-ERTA amendments. In this regard, while Treasury treats an amendment to a nonqualified option as the granting of a new option under section 425(h) in order to require a repricing of the option, Treasury does not apply section 425(h) in the same manner to a nonqualified option that was granted before 1976 and amended after that date.

In the latter situation the Treasury holds that a subsequent amendment will not be treated as the granting of a new option for purposes of meeting the January 1, 1976, qualification date. There is no logic or reason for these obviously inconsistent positions taken by Treasury other than to undermine, by administrative fiat, Congress intent to permit retroactive application of the ISO provisions.

Treasury's position must stem from philosophical or political rather than fiscal considerations since restricting retroactive treatment of the ISO provisions will result in a revenue loss. Conversely, the clarifying technical amendment we propose will generate additional revenues, and I would add here it is a small point, Mr. Chairman, but we are proposing something that increases Federal revenues.

They are proposing something that reduces revenues at a time when the growing Federal deficit is causing exceptionally high interest rates which are throwing more and more Americans out of work and pushing economies all over the world into deeper and longer recessions. And to my way of thinking, that don't make much sense.

Thank you very much.

[Subsequent to the hearing, the committee received the following letter:]

BAKER & MCKENZIE
ATTORNEYS AT LAW

815 CONNECTICUT AVENUE, N. W.
WASHINGTON, D. C. 20006
TELEPHONE (202) 298-8290
TELECOPIER (202) 338-1206
CABLE ABOGADO
TELEX 89-552 (WU)
248441 (RCA)

AMSTERDAM
BANGKOK
BOGOTA
BRUSSELS
CARACAS
CHICAGO
FRANKFURT
GENEVA
HONG KONG
LONDON
MADRID
MANILA
MEXICO CITY
MILAN
MINNEAPOLIS
NEW YORK
PARIS
RIO DE JANEIRO
ROME
SAN FRANCISCO
SAO PAULO
SYDNEY
TAIPEI
TOKYO
TORONTO
WASHINGTON, D.C.
ZURICH

April 30, 1982

The Honorable Dan Rostenkowski, Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Rostenkowski:

At the public hearing held on April 27, 1982, by the Committee on Ways and Means regarding the proposed Technical Corrections Act of 1982, testimony was presented by Mr. Peter T. Jones, Senior Vice President of Levi Strauss & Co., with respect to a proposed technical amendment to the incentive stock option ("ISO") legislation. During the course of his testimony, Mr. Jones referred to a letter written in March, 1982, by Assistant Secretary John E. Chapoton to Rep. Barber B. Conable in which Mr. Chapoton attempted to present a technical and legal defense of the position taken by the Treasury Department in its Temporary Regulations that the section 425(h) "repricing rule" should be applied on a retroactive basis to nonqualified stock options elected for ISO treatment under the section 422A transitional rules. For your convenience, a copy of Mr. Chapoton's letter is attached hereto.

Due to the limited time available for testimony at the public hearing, Mr. Jones was not able to include as part of his oral presentation a response to the legal position set forth in Mr. Chapoton's letter. Accordingly, we hereby submit for the record the following legal analysis demonstrating that, contrary to Mr. Chapoton's expressed view, there exists absolutely no statutory or other legal foundation for Treasury's position on this issue.

Mr. Chapoton's defense rests on his dual assertions that section 425(h) retroactivity is supported both by the language of the statute (section 251 of ERTA) as well as by the Conference Report issued with respect to ERTA. Both such assertions, however, cannot withstand careful legal scrutiny.

With respect to Mr. Chapoton's contention that the language of section 251 of ERTA supports section 425(h) retroactivity, his legal argument is as follows:

> This rule appeared to us to be dictated by the statute, which provides ISO treatment retroactively to certain options granted after 1975, only if the corporation "elects to have the amendments made by [ERTA section 251] apply to such option[s]." *The amendments made by ERTA section 251 include a modification of Code section 425(h), to incorporate ISOs within this statutory reprice rule.* Thus, as part of this "election" of ISO treatment a corporation automatically elects to have its historic option amendments scrutinized under section 425(h). [Emphasis supplied]

Thus, Mr. Chapoton's "statutory" defense of Treasury's position is composed of the three separate sentences quoted above. However, a careful examination reveals that his entire argument actually rests upon the single statement made in the second underscored sentence, since the first sentence merely restates the statute and the final sentence is conclusionary.

Focusing then on this second sentence, we submit that his statement is factually and legally inaccurate and, thus, cannot support a statutory basis for Treasury's position. In this regard, a careful reading of the statute reveals that the "amendments made by section 251" do not include a modification of section 425(h) to incorporate ISO's within the repricing rule. To the contrary, "the amendments made by section 251" contain only two "modifications" which relate to section 425(h),*/ neither of which can be read "to incorporate ISOs within [the] statutory reprice rule." In fact, both such "modifications" relate to exceptions from the normal section 425(h) requirements. Thus, the inaccuracy of this second sentence, which is the very heart of his assertion that Treasury's position is supported by the statutory language of section 251, causes Mr. Chapoton's entire "statutory" defense to fall of its own weight.**/

---

*/ Sections 251(b)(4) and (c)(2).

**/ We do not dispute the fact that ISO's are incorporated within the section 425(h) repricing rule; however, we submit that, for the reasons set forth in Mr. Jones' oral and written testimony, such incorporation is on a prospective (Continued)

Moreover, the weakness of Mr. Chapoton's legal position is further evidenced by his third and final sentence, which, although conclusionary and based upon a false premise, appears to present a legal position directly contrary to a position taken by Treasury in its Temporary Regulations. Specifically, this third sentence, when read together with the two preceding sentences, strongly suggests that as part of any ISO election, the company also automatically elects to have all of the "amendments made by section 251" apply to such elected options. This, however, is directly contrary to the position set forth in A-25 of the Temporary Regulations which permits only mandatory amendments to the elected options and provides that the making of permissive amendments will result in a section 425(h) modification. Mr. Chapoton's logic, however, suggests that by making the election the company automatically elects to have all of the section 251 amendments, both mandatory and permissive, apply to the elected options.

In his letter to Rep. Conable, Mr. Chapoton goes on to state that Treasury's "rescind or reprice" alternative is supported by the following excerpts taken from p. 235 of the ERTA Conference Report:

**/ (Continued)
basis only and results not from the "amendments made by section 251" but rather from the language of section 425(h)(1) which, by its very terms, applies to sections 421 through 425 of the Code.

> In the case of an option granted before 1982, the modification or deletion of any stock appreciation right . . . to permit the option to qualify as an incentive stock option can be made within one year of enactment of [ERTA]. . . In addition, the terms of a stock option plan or an option issued before 1982 can be modified to conform to the incentive stock option rules . . .

At the outset, these two partial sentences quoted by Mr. Chapoton do not on their face lend any support for, or even pertain to, Treasury's "rescind or reprice" alternative. However, even if Mr. Chapoton were able to demonstrate some logical connection between the quoted statements and the "rescind or reprice" alternative, his Conference Report "authority" is meaningless for the following basic reason: Mr. Chapoton has chosen his "supportive" quotations not from the portion of the ERTA Conference Report dealing with the agreements made by the House and Senate conferees but rather from that portion of the Conference Report which sets forth the position of the Senate Finance Committee with respect to its version of ERTA.

Under most circumstances, reference to statements contained in the Senate Finance Committee Report would not be misleading in attempting to interpret a particular ISO provision since the conferees, for the most part, accepted the Senate's version of the ISO statute. However, and this is a point that cannot be emphasized too strongly, the first statement quoted by Mr. Chapoton in his letter to Rep. Conable pertains solely to a provision contained in the Senate version of 251(c)(2)(A), which provision was deleted by the conferees from section 251(c)(2) and which, therefore, does not appear in the final statute.***/

Accordingly, we submit that Mr. Chapoton's asserted legal rationale for Treasury's "rescind or reprice" alternative must also be rejected since, to the extent it is even comprehensible, it is premised on a Committee Report statement relating to a non-existent statutory provision.

In summary and for the reasons set forth above, we respectfully submit that Treasury's legal defense of its position on the section 425(h) retroactivity issue is devoid of any relevant or meaningful legal authority or rationale and, accordingly, serves only to underscore and highlight the validity of the legal arguments in support of a non-retroactive application of

---

***/ The Senate version of section 251(c)(2)(A), prior to deletion by the conferees, read as follows:

> (2) CHANGES IN TERMS OF OPTIONS. - In the case of an option granted before January 1, 1982, paragraph (1) of section 425(h) of the Internal Revenue Code of 1954 shall not apply -
>
> (A) to any change made before the date which is not more than 12 months after the date of enactment of this Act in the -
>
> (i) plan under which such option was granted, or
>
> (ii) terms of such option,
>
> to permit the modification or deletion of a stock appreciation right or other rights to cash payments concurrent with exercise of the option,

section 425(h) as expressed by Mr. Jones in his oral presentation and written testimony.

Respectfully submitted,

Dennis Meyer

Dennis I. Meyer

DIM:am
Enclosure

CURRENT AND QUOTABLE

Chapoton on the Incentive Stock Option 'Shadow' Rule

On November 9, 1981, Dennis J. Taylor of the Washington firm of Cummings & Lockwood prepared a memorandum for Treasury Assistant Secretary for Tax Policy John E. Chapoton relating to the so-called "shadow" rule for modifications made to stock options that were outstanding prior to enactment of ERTA. See Tax Notes, November 30, 1981, p. 1296 and Doc 81-11209. Subsequently, a copy of the Taylor memo was sent to Assistant Secretary Chapoton by Rep. Barber B. Conable, Jr., R-N.Y., the ranking Republican on the House Ways and Means Committee.

Set forth below is the full text of Chapoton's March 1982 response to Conable. The Chapoton letter has also been placed in the March 22, 1982 Tax Notes Microfiche Data Base as Doc 82-3442.

Dear Barber:

Thanks for forwarding me a copy of the Cummings & Lockwood memorandum by Dennis Taylor, Esq., which raised an issue concerning the undesirable effect of the temporary Incentive Stock Option (ISO) regulations on the firm's client, the Perkin-Elmer Corporation.

As anticipated in that memorandum, the temporary ISO regulations, which were issued on December 17, 1981, provide that the "reprice rule" of Code section 425(h) applies retroactively (as well as prospectively) to any options elected or qualifying for ISO treatment. This rule appeared to us to be dictated by the statute, which provides ISO treatment retroactively to certain options granted after 1975, only if the corporation "elects to have the amendments made by [ERTA section 251] apply to such option[s]." The amendments made by ERTA section 251 include a modification of Code section 425(h), to incorporate ISOs within this statutory reprice rule. Thus, as part of this "election" of ISO treatment a corporation automatically elects to have its historic option amendments scrutinized under section 425(h).

This retroactive application of section 425(h) is not inflexible, however. Both Treasury and the Internal Revenue Service realized that many corporations had amended their nonqualified options during 1979 and 1980 to add stock-for-stock exchange features and stock appreciation rights. As a result, the temporary regulations offer corporations which seek to qualify outstanding options for ISO treatment a choice between raising the option price to fair market value as of the amendment date, or restoring the original option terms, with a price set at fair market value as of the original grant date. This rule also appears to be supported by the Conference Report discussion of ISOs which states that:

> [i] *In the case of an option granted before 1982, the modification or deletion of any stock appreciation right . . . to permit the option to qualify as an incentive stock option can be made within one year of enactment of [ERTA] . . . . In addition, the terms of a stock option plan or an option issued before 1982 can be modified to conform to the incentive stock option rules . . . .*
> [*ERTA Conference Report at 235.*]

By offering this choice between deleting modifications or repricing options, the temporary regulations, in effect, permit corporations to evaluate retroactively the merits of option amendments that they never realized would someday be subject to section 425(h).

The temporary regulations, in effect, permit corporations to evaluate retroactively the merits of option amendments that they never realized would someday be subject to section 425(h).

We hope that the temporary ISO regulations were responsive to Cummings & Lockwood's concerns in this area.

The following language should be inserted beginning on line 25 of page 19 of H.R. 6056:

(7) Paragraph (2) of section 251(c) of the Economic Recovery Tax Act of 1981 (relating to changes in terms of options) is amended by inserting "(A)" immediately following "CHANGES IN TERMS OF OPTIONS.--" and by adding the following new subparagraph:

"(B) In the case of an option granted on or after January 1, 1976, and exercised on or after January 1, 1981, or outstanding on such date, paragraph (1) of section 425(h) of the Internal Revenue Code of 1954 shall not apply to any change in the terms of such option (or the terms of the plan under which granted), if such change was made prior to the date of the enactment of this Act and at a time and date that section 422 did not apply to such option."

~~(2) Effective only with respect to amounts paid or incurred after March 31, 1982, clause (iii) of section 44F(b)(2)(A) is amended to read as follows:~~

~~"(iii) any amount paid or incurred to another person for computer time for the conduct of qualified research where the principal use of such computer is by persons other than the taxpayer and persons related to the taxpayer."~~

~~(i) AMENDMENT RELATED TO SECTION 234.—Subparagraph (B) of section 1371(g)(3) (defining qualified subchapter S trust) is amended to read as follows:~~

~~"(B) all of the income (within the meaning of section 643(b)) of which is distributed (or required to be distributed) currently to 1 individual who is a citizen or resident of the United States, and".~~

(j) AMENDMENTS RELATED TO SECTION 251.—

(1) Paragraph (8) of section 422A(b) (defining incentive stock option) is amended by striking out "granted options" and inserting in lieu thereof "granted incentive stock options".

(2) Paragraph (1) of section 422A(c) (relating to exercise of option where price is less than value of stock) is amended—

(A) by adding at the end thereof the following new sentence: "To the extent provided in regulations by the Secretary, a similar rule shall apply for purposes of paragraph (8) of subsection (b) and paragraph (4) of this subsection.", and

(B) by striking out the paragraph heading and inserting in lieu thereof the following:

"(1) GOOD FAITH EFFORTS TO VALUE STOCK.—".

(3) Subparagraph (A) of section 422A(c)(2) (relating to certain disqualified dispositions where amount realized is less than value at exercise) is amended by striking out "the 2-year period" and inserting in lieu thereof "either of the periods".

(4) Clause (ii) of section 422A(c)(4)(A) (relating to carryover of unused limit) is amended by striking out "granted options" and inserting in lieu thereof "granted incentive stock options".

(5) Subsection (j) of section 425 (relating to cross references) is amended by inserting "an incentive stock option," after "qualified stock option,".

(6)(A) Subsection (c) of section 425 (defining disposition) is amended by adding at the end thereof the following new paragraph:

"(3) SPECIAL RULE WHERE INCENTIVE STOCK IS ACQUIRED THROUGH USE OF OTHER STATUTORY OPTION STOCK.—

"(A) NONRECOGNITION SECTIONS NOT TO APPLY.—If—

"(i) there is a transfer of statutory option stock in connection with the exercise of any incentive stock option, and

"(ii) the applicable holding period requirements (under section 422(a)(1), 422A(a)(1), 423(a)(1), or 424(a)(1) are not met before such transfer,

then no section referred to in subparagraph (B) of paragraph (1) shall apply to such transfer.

"(B) STATUTORY OPTION STOCK.—For purpose of subparagraph (A), the term 'statutory option stock' means any stock acquired through the exercise of a qualified stock option, an incentive stock option, an option granted under an employee stock purchase plan, or a restricted stock option."

(B) Paragraph (1) of section 425(c) is amended by striking out "paragraph (2)" and inserting in lieu thereof "paragraphs (2) and (3)".

~~(k) AMENDMENT RELATED TO SECTION 252~~.—

Mr. **Matsui**. Thank you very much. Do any members have any questions?

[No response.]

Mr. **Matsui**. Thank you very much. We appreciate your testimony and certainly your earlier comments reminiscing on having formerly served this committee. Thank you.

Mr. **Jones**. Thank you very much.

Mr. **Matsui**. At this time I would like to call the following panel: Mr. Robert Parkin, city attorney, city of Long Beach, representing the California State Lands Commission; Mr. H. B. Scoggins, Jr., general counsel and vice president, Government relations, for the Independent Petroleum Association of America; Mr. Chester R. Upham, Jr., chairman of the board, Texas Independent Producers & Royalty Owners Association; and Mr. John Watson, vice president for Governmental affairs, Mitchell Energy & Development Corp.

We welcome you to the committee. All of your written testimony will be submitted for the record. We will call upon you in the order in which I read your names.

Mr. Parkin.

STATEMENT OF ROBERT PARKIN, ESQ., CITY ATTORNEY, CITY OF LONG BEACH, REPRESENTING THE CALIFORNIA STATE LANDS COMMISSION AND THE CITY OF LONG BEACH, CALIF.

Mr. **Parkin**. Yes, Mr. Chairman. I appear here on behalf of the State of California and the city of Long Beach as to the problem we have. It is a common one. I think the staff analysis of the proposed technical amendments characterizes our problem properly and that the language used in the Windfall Profit Tax Act defines producers subject to this tax and State and local government entities which are to be exempt from it in terms of their economic interest in oil production.

This term "economic interest" has a special meaning in income tax law and we believe was inadvertently used in the act, particularly when one looks at the result of its application to net profit contracts. The problem arises from the fact that the windfall profit tax is imposed on the proceeds of the sales of barrels of oil removed from the property, rather than upon income attributable to the holder of an economic interest.

Thus, the amount subject to the tax includes money representing recovery of cost, and under this "economic interest" concept that money is attributed to the operating interest as the one ordinarily bearing the risk of loss.

As a result, although California and Long Beach receive about 95 percent of the net profits and the oil companies only 5 percent, this concept gives the oil companies an economic interest amounting to about 30 percent of the income from the operation, leaving California and Long Beach an economic interest of only 70 percent.

California, Long Beach, the Treasury, and the congressional staff prepared a correcting technical amendment which with one change is included in section 201(h) of H.R. 6056. The change I refer to is a new definition of "producer for net profits interests" which applies only to agreements entered into or renewed after March 31, 1982.

In order to make the application of the governmental exemption to California and Long Beach apply to their entire net profit shares, we urge adoption of a further technical amendment adding a paragraph (d) to section 203 of the bill dealing with effective dates. This proposed technical amendment makes inapplicable the requirement that net profits agreements involving exempt governmental entities with a net profit interest of 90 percent or more be entered into or renewed after March 31, 1982 in order to come within the scope of the technical correction for net profits interests contained in section 201(h) of the bill.

Thank you, Mr. Chairman. I would be glad to answer any questions of any of the members.

[The prepared statement follows:]

STATEMENT OF ROBERT PARKIN, CITY ATTORNEY, CITY OF LONG BEACH, CALIF.

I appear today on behalf of the State of California and the City of Long Beach, to urge adoption of an amendment adding a proposed sec. 203(d) to H.R. 6056. The proposed new section will make a technical correction to the Crude Oil Windfall Profit Tax Act of 1980 perfecting the exemption originally intended to be given to qualified governmental interests in net profits operations. The Treasury has no objection to our proposal.

The State of California owns significant offshore oil deposits on state-owned tidelands. The principal deposits are in tidelands granted in trust to the City of Long Beach. These deposits were developed pursuant to net profits contracts awarded to oil companies bidding the largest percentage of net profits to be given to California and Long Beach. Under each of these contracts, California and Long Beach receive in excess of 90 percent of the net profits.

The exemption for qualified governmental interests included in the Windfall Profit Tax Act was designed to assure that revenues paid to state and local governments from the sale of oil allocable to their interests would not be subject to the windfall profit tax. Members of the House and Senate from California who worked most diligently for this governmental exemption were fully aware that the most significant interests in oil held by California and Long Beach were in the form of net profits shares, rather than the more usual royalty interests. It was clearly their understanding and the understanding of the Congress that the exemption would fully apply to the State of California's production and thus to these net profits shares. However, the language used in the Windfall Profit Tax Act defined producers subject to the tax and state and local government entities who were to be exempt from it in terms of their "economic interests" in oil production.

The technical term "economic interest", commonly used in income tax law, with a meaning developed over many years by decisions of the Internal Revenue Service and the federal courts, creates a very serious problem when used to apply the windfall profit tax to all net profits contracts, a problem that was not recognized when the Windfall Profts Tax Act was passed.

This problem is particularly serious when the "economic interest" concept is applied to the nearly unique net profits operations carried out by California and the City of Long Beach under the detailed requirements of state statute. In effect, it very substantially reduces the size of the nonoperating exempt governmental interest and enlarges the taxable operating interest of the oil companies who are conducting the production operations as contractors with the State and City. Accordingly, it very seriously enlarges the total windfall profits tax burden on these net profits operations, an increased burden which falls directly on the State of California and the City of Long Beach in the form of reduced net profits.

Briefly and simply, the problem with applying the windfall profit tax to economic interests in net profits operations arises from the fact that the windfall profit tax is imposed on the proceeds of sales of barrels of oil removed from the property rather than on income attributable to the holder of an economic interest. Thus, that income includes money representing recovery of costs, and, under the economic interest concept, that income is to be attributed to the operating interest as the one ordinarily bearing the risk of loss. Under California's and Long Beach's net profits contracts, this interest was held to be the net profit share held by the oil companies operating under contract. Although California and Long Beach receive about 95 percent of the net profits and the oil companies receive only 5 percent, the oil companies, because they bear the apparent risk of loss, are allocated all income representing recovery of costs. This gives the oil companies an economic interest amounting to about 30 percent of the income from the operation, leaving California and Long Beach an economic interest of only 70 percent.

California and Long Beach have worked closely with Treasury and the Congressional staff over the past two years to correct the method of applying the windfall profit tax to net profits interests and, thereby, secure the originally intended exemption for their own net profits interests. California, Long Beach, Treasury Department and the Congressional Joint Committee staff prepared a correcting technical amendment that defines the economic interest of a producer in a net profits operation as including a share of the cost recovery oil, that is, oil produced and sold which represents a recovery of costs, allocated in proportion to the interest holder's share of net profits. This would mean that a holder of a 95 percent share of net profits would be allocated 95 percent of the barrels of removed oil.

This technical amendment, with one change, is included in Section 201(h) of H.R. 6056. The change is that the new definition of producer for net profits interests applies only to agreements entered into or renewed after March 31, 1982. This change was necessary to prevent any adverse effect on those who relied on the original language, but, because of the change, the technical amendment does not resolve California's and Long Beach's problems with their contracts that were entered into many years ago. Two matters required technical correction. These were the application of the windfall profit tax to net profits interests generally and the application of the governmental exemption to California's and Long Beach's entire net profits shares. The bill in its present form does only the former; it does not do the latter.

California and Long Beach are urging adoption of this technical amendment, prepared by the Congressional staff, to make the necessary correction to the application of the windfall profit tax to governmental net profits interests. The amendment adds a paragraph (d) to Section 203 of the bill dealing with effective dates. It makes the requirement that net profits agreements be entered into or renewed after March 31, 1982, in order to come within the scope of the technical correction for net profits interests in Section 201(h) of the bill, inapplicable to net profits interests held by governmental entities where the government receives 90 percent or more of the net profits. This language would encompass all of California's and Long Beach's net profits contracts, but would affect no others because no other states or local governments yet have net profits agreements. The amendment that is offered would give California's and Long Beach's net profits interests the same full exemption that other governmental interests were given and that all governmental interests, including net profits interests, were intended to have from the time the windfall profit tax was first imposed.

Mr. MATSUI. Mr. Scoggins.

STATEMENT OF H. B. SCOGGINS, JR., GENERAL COUNSEL AND VICE PRESIDENT, GOVERNMENT RELATIONS, INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

Mr. SCOGGINS. Thank you, Mr. Chairman. I am Bud Scoggins, representing the Independent Petroleum Association of America and some 30 unaffiliated State and regional producers associations. Together we represent essentially all of the 15,000 independent producers who account for 90 percent of the wells drilled in the United States.

Mr. ARCHER. Mr. Chairman, I admit my hearing is not the best, but I am having very great difficulty hearing the witness. I do not know what the problem is, but it is hard to hear.

Mr. MATSUI. Your comments are well taken. May we have quiet in the hearing room if at all possible? Those persons who would like to engage in conversation, please go in the back of the room or the hallways.

Excuse me, Mr. Scoggins, will you please proceed?

Mr. SCOGGINS. Thank you. I will limit my comments to those portions of the legislation dealing with the crude oil excise tax and provisions relating to oil and gas properties. The liberalization of withholding adjustments for the windfall tax is certainly a much-needed change. However, there could still be some confusion and possible inequities due to a lack of knowledge on the part of the producer that a change in withholding has occurred.

We therefore recommend that the first purchaser be required to give notice to the producer or royalty owner prior to making a change in which withholding would exceed the amount of the windfall profit or which would be withholding for crude oil removed from the property in the previous calendar year.

The so-called "deemed payment date provision" provided by section 4995 of the act, we think, is an unnecessary provision which should be eliminated. The producer's money is withheld from him at the time the oil is purchased and payment is made. Treasury receives the deposit of these funds often even before the producer has been paid for the crude oil. We think equity requires that the tax be deemed to have been paid at the time it is withheld or at least at the time that the funds are deposited with the Treasury rather than being deemed to have been paid the last day of February of the following year.

The proposed change in the definition of crude oil has already been much discussed and I will abbreviate my comments with regard to that by saying we share very much the concerns that have been expressed by members of the committee. We think the proposed change goes far beyond anything that could be classified as a technical correction. It is a substantive change which we think should be stricken from the bill entirely.

The proposed amendment concerning transfers of producing properties to controlled corporations is definitely a needed clarification of existing law. However, in its present form the amendment would still leave sufficient uncertainty to permit misinterpretation. It is important for the provision to include within the definition of property such items as pumps, tanks, flow lines, separators, meters, gages, and other similar equipment located on the surface of the producing property.

Anything located physically within the bounds of the property being transferred should be included within the definition, while facilities not physically located on the producing property should be excluded from the definition.

I would like to address a couple of items which are not presently in the bill but which we urge the committee to consider and incorporate. The present provisions of the windfall tax implementing the net income limitation require producers to engage in some extremely complex computations, usually requiring the use of information which is not normally within a producer's financial records.

The computations have to be applied to each separate property and then to each separate barrel of oil that has been produced and sold. The smaller producers and royalty owners are totally ill-equipped to deal with the complex computations required and therefore they are not getting any benefit of the net income limitation provision and they are the ones who most need to utilize this provision.

It would greatly simplify the procedure for both producers and the IRS if the net income limitation were applied using aggregate property-by-property computations, which is the normal way for accounting in the petroleum industry. The end result would be essentially the same. There would be no revenue impact to the Treasury, but the amount of paper flow between producers and the Treasury would be significantly reduced. But the quality of information available would be substantially improved.

Those integrated companies and larger independents who have the necessary sophistication and computer techniques to handle the existing complex provisions and who want to continue using the existing law could have an election to either use the present provision or to use the average property-by-property computations. We think this would be a significant improvement for all concerned.

One additional item we think is urgently needed is correction of confusion in the existing law concerning the phasedown on the rate of percentage depletion for secondary and tertiary production. In providing for the phasedown in the statutory rate of depletion from 22 percent to 15 percent over a period of time beginning in 1981 and ending in 1984, Congress recognized the higher cost and, therefore, the need of additional incentives for secondary and tertiary production.

Thus, it was provided that the rate of depletion for such production would remain at 22 percent through 1983 and beginning in 1984 it would drop in one step to the 15-percent rate, which is applicable or would be applicable at that time for all other production. However, ambiguities in the present law have provided confusion, and there is indication from the Department of Treasury that they have a different interpretation of this provision. We would urge the staff and the committee to address this problem.

We would welcome the opportunity to provide the committee with specific suggested language for each of these items to which we have referred. Thank you for your attention.

[The statement of Mr. Scoggins follows:]

STATEMENT OF H. B. SCOGGINS, JR., INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA AND AMERICAN ASSOCIATION OF PETROLEUM LANDMEN; ARKOMA BASIN INDEPENDENT GAS PRODUCERS ASSOCIATION; CALIFORNIA INDEPENDENT PRODUCERS ASSOCIATION; EASTERN KANSAS OIL & GAS ASSOCIATION, INC.; ILLINOIS OIL & GAS ASSOCIATION; INDEPENDENT OIL & GAS ASSOCIATION OF WEST VIRGINIA; INDEPENDENT OIL PRODUCERS TRI-STATE, INC.; INDEPENDENT PETROLEUM ASSOCIATION OF MOUNTAIN STATES; INDEPENDENT PETROLEUM ASSOCIATION OF NEW MEXICO; INDIANA OIL & GAS ASSOCIATION; KANSAS INDEPENDENT OIL & GAS ASSOCIATION; KENTUCKY OIL & GAS ASSOCIATION; LIAISON COMMITTEE OF COOPERATING OIL & GAS ASSOCIATIONS; LOUISIANA LANDOWNERS ASSOCIATION, INC.; LOUISIANA ASSOCIATION OF INDEPENDENT PRODUCERS & ROYALTY OWNERS; MICHIGAN OIL & GAS ASSOCIATION; NATIONAL STRIPPER WELL ASSOCIATION; NEW YORK STATE OIL PRODUCERS ASSOCIATION; NORTH TEXAS OIL & GAS ASSOCIATION; OHIO OIL & GAS ASSOCIATION; OKLAHOMA INDEPENDENT PETROLEUM ASSOCIATION; PANHANDLE PRODUCERS & ROYALTY OWNERS ASSOCIATION; PENNSYLVANIA GRADE CRUDE OIL ASSOCIATION; PENNSYLVANIA OIL & GAS ASSOCIATION; PERMIAN BASIN PETROLEUM ASSOCIATION; ROYALTY OWNERS & INDEPENDENT OIL & GAS PRODUCERS ASSOCIATION OF ARKANSAS; TENNESSEE OIL & GAS ASSOCIATION; TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION; VIRGINIA OIL & GAS ASSOCIATION; WEST CENTRAL TEXAS OIL & GAS ASSOCIATION

My name is H. B. Scoggins, Jr. I am representing the Independent Petroleum Association of America (IPAA), a national organization of independent petroleum explorer-producers, having almost 8,000 members in every producing area of the nation. Together with the thirty unaffiliated state and and regional associations which join us in these comments, we represent essentially all of the 15,000 independent oil and gas producers who account for about 90 percent of all the drilling in the United States. We welcome and appreciate this opportunity to express our views on technical corrections legislation under consideration by this committee.

My testimony will be limited to those portions of the legislation related to the crude oil excise tax and the provision dealing with transfers of proven oil and gas properties to controlled corporations. We commend the staff and the committee for this effort which has been made to address several critical technical problems and administrative difficulties. We would like to call attention to several sensitive areas and pitfalls which require special attention or modification. There are also some items not included in the legislation which we feel should be considered and added to the bill before it is reported out by the committee.

WINDFALL PROFIT TAX—WITHHOLDING ADJUSTMENTS

The liberalization of withholding adjustments by the amendment to Section 4995(a)(3) (A) and (C) is generally a desired change. However, there could be situations where inequities would result or confusion exist due to a lack of knowledge on the part of the owner of the economic interest. It is recommended that the first purchaser or other party withholding give prior notice and obtain consent from the producer or economic interest owner prior to initiating withholding in excess of the windfall profit or beyond the close of the calendar year of removal. There are still many instances where small producers and royalty owners will be subject to withholding and the protection intended by the original provision should be maintained through the notice requirement.

DEEMED PAYMENT DATE OF WINDFALL PROFIT TAX

The "deemed payment date" provided by Section 4995(a)(4) is unnecessary and should be eliminated. The producer is denied receipt of the funds from the time of withholding and Treasury receives the funds either twice a month or within 45 days following the month of removal, which is often more quickly than the producer receives payment for the oil. Only in those instances involving certain small refiners which have extended periods for deposit is this not true. Accordingly, equity requires that the tax be "deemed paid" at the time it is withheld or, at the least, at the time it is deposited by the withholding agent.

NET PROFITS INTERESTS

The amendment to Section 4996(a) to modify the present treatment of net profits interests is intended to deal with a very limited special interest problem involving only net profits interests held by governmental entities which would normally be exempt. The proposed change will affect all net profits interest whether held by exempt governmental entities or otherwise. It will in many instances require development of new contractual arrangements to deal with a type of financial transaction quite common throughout the petroleum industry and involve the adoption of a complete new body of interpretive law and likely create administrative problems for income tax purposes as well. The intended objective can be achieved just as readily but without creating unnecessary confusion, administrative and contractual problems for all others by limiting the amendment to net profits interests held by qualified governmental entities.

DEFINITION OF CRUDE OIL

The proposed change of the definition of "crude oil" in section 4996(b) is an apparently innocuous provision which, in reality, involves significant change in substantive law and goes far beyond anything that can be considered a technical correction. The proposed language "such term includes condensates recoverable from natural gas (whether or not recovered before the natural gas is removed from the premises)" would open a veritable Pandora's box of practical and administrative problems for producers and the IRS.

The proposal relates to the different engineering methods that are used to separate or extract liquids from what is often referred to as "wet gas." This proposal is not a noncontroversial one. Rather it is a controversial proposal involving policy considerations that Congress has not previously addressed.

It is recommended that this provision be deleted from H.R. 6056 so that Congress can carefully review the diverse and complex issues involved in formulating the most appropriate definition of crude oil. The proposed change raises many problems.

Under the DOE regulations that were incorporated in the Windfall Profit Tax Act, certain liquids that were actually recovered from natural gas were subject to oil price controls. Under the proposal, liquids which are "recoverable" from natural gas as condensate would be treated as crude oil for purposes of the windfall profit tax. This concept of "recoverable" was never included in the oil price control program. It is not included in the present version of the crude oil windfall profit tax. Thus, H.R. 6056 introduces a new legal concept for the energy industry. This is far more than a mere clerical or technical change.

The legislation raises numerous complex questions such as what does the concept of "recoverable" mean, what standards will be applied in measuring what is recoverable, and is necessary measuring equipment in place. Complex engineering and technical concepts are involved in determining what is "recoverable" and conditions are different for different geographic areas and different geologic formations.

The effect of the proposal would be to subject some natural gas to duplicate federal regulation. Generally, the price of the natural gas at the wellhead is subject to price controls under the Natural Gas Policy Act. Under the proposal, a portion of the regulated gas would also be taxed under the Crude Oil Windfall Profit Tax Act. At a time when Congress is attempting to reduce unnecessary governmental regulation, every effort should be made to avoid duplicate regulatory systems. A windfall profit tax on natural gas should not be enacted for the first time as part of a "technical corrections" bill on crude oil taxes.

Real administrative problems for some taxpayers could result. In many instances it would be difficult to determine which natural gas producers are liable for which portions of the tax. It would be impossible to determine the correct category of oil or tax tier to which the condensate should be assigned.

Another problem created by this proposal is that the change would be made retroactive to the effective date of the Crude Oil Windfall Profit Tax Act. The crude oil tax generally was applied to oil removed after February 29, 1980. Thus, producers could be taxed retroactively as a result of a major policy change. The administrative difficulties and potential inequities are enormous. This proposal should be deleted from this legislation.

TRANSFERS TO CORPORATIONS

The proposed amendment to Section 613(A)(c)(10) is a much needed clarification of present ambiguity. It is intended to clarify the meaning of the term "oil or gas property" in transactions where a producer is transferring presently owned producing property to a controlled corporation in a tax free transaction. Normally in such transfers the entire producing property or lease, including the mineral interest and all tangible and intangible equipment located thereon, is transferred. Custom and usage has always accorded to the term "oil or gas property" or "producing property" a meaning encompassing all tangible and intangible property physically located on the lease. The proposed amendment would appear to leave open sufficient ambiguity to permit continued uncertainty and misinterpretation. We will provide the staff with language we suggest in place of the proposed amendment.

It is important that the provision include such things as surface pumps, tanks, flow lines, separators, gauges, meters, and similar equipment which are all part of the production operation on the property. Any facilities not physically located on the producing property would be excluded.

ITEMS NOT PRESENTLY INCLUDED

Windfall profit tax—net income limitation. Section 4988(b) concerning the net income limitation requires producers to engage in some extremely complex computations to determine whether the net income limitation is applicable on a particular producing property and then to apply it to each barrel of oil separately. For royalty owners and smaller producers the sophisticated techniques and highly specialized professional assistance generally required to properly make such computations are beyond reach. Accordingly, these producers, the very ones most in need of the benefits intended by the net income limitation, are unable to secure any benefits. Income tax accounting and financial record keeping for other purposes is maintained on property-by-property basis, not on a barrel-by-barrel basis. It would greatly simplify the required computation by producers and auditing and administration by the IRS if the net income limitation is applied using aggregate property-by-property computations instead of barrel-by-barrel. Except in very rare instances, the end result will be virtually identical and for all practical purposes there would be no revenue impact.

For the large integrated producers and larger independents who have the necessary computers and professional accounting and tax specialists to cope with the existing, extremely complex per barrel computations and who wish to continue with the present method, an election can be provided. As a practical matter there would be relatively few taxpayers, out of the many thousands of producers filing returns, who would continue utilizing the per barrel computation. The simplification of changing to an aggregate property-by-property method would result in very substantial reductions in the amount of information reporting required between first purchasers and producers. Since copies of all of the various reports are required to filed with IRS it would obviously result in very substantial reductions of the volume of paper, but significantly increase the quality of the information reported. We urge your consideration of this proposal and would welcome the opportunity to provide the staff with specific suggested legislative language.

Royalty owner exemption.—Last year when Congress adopted the exemption from windfall profit tax for small royalty owners, the legislative language was abundantly clear as to the amount intended to be exempt. Section 4994(f)(2)(A) provided in part that: "a qualified royalty owners royalty limit for any quarter is the product of (i) the number of days in such quarter multiplied by . . ." either 2 barrels per day for 1982, '83, and '84, or 3 barrels per day beginning in 1985. However, IRS when issuing forms and regulations for implementing this provision appears to have ignored the clear legislative directive and provided that the amount of the exemption is 2 barrels each day (3 barrels beginning 1985) without regard to the number of days in the quarter. Since the statutory language is abundantly clear, it appears that some further expression of congressional intent in the committee report is required.

Also, Form 6783 for certifying exemption from withholding as a qualified royalty owner restricts applicability of the exemption from withholding to situations when "all of my production from the property" qualifies for exemption. This would prohibit certification by a royalty owner who had, for example, 2½ barrels per day of royalty, thereby negating a significant part of the benefit intended to be conferred by adoption of the royalty owner exemption. This would require such royalty owners to wait until after the close of the year to claim a refund or credit against income taxes. This defeats the intent of providing holders of small royalty interest current income and reducing the amount of overwithholding and refund claims required after the close of the taxable period or income tax year. We suggest that Section 4995(a), "Withholding by Purchaser," be amended by adding a specific directive that regulations provide for adjustment of withholding in cases where a royalty owner's qualified royalty production exceeds the 2 or 3 barrel per day limit, with total combined withholding exemption not to exceed the amount equal to the tax on the appropriate royalty limit.

Production from secondary or tertiary processes.—One additional item urgently needed to be included in this legislation is to correct confusion resulting from an ambiguity in the provisions of Section 613(A)(c)(6) pertaining to production from secondary or tertiary processes. In providing for a phase down in the statutory rate of depletion from 22 percent to 15 percent over a period of years beginning in 1981, congress recognized the higher costs and need for additional incentives for production resulting from secondary or tertiary processes. Thus it was provided that the rate for such production will remain at 22 percent through December 31, 1983 and then drop in one step to the 15 percent rate applicable for all other production beginning January 1, 1984. However, the juxtiposition of the provision for the termination of paragraph "(6) Oil and natural gas resulting from secondary or tertiary processes" on December 31, 1983, and the ambiguous reference to production of crude oil or natural gas resulting from secondary or tertiary processes in the determination of "average daily production" in paragraph 613(A)(c)(2), has caused some confusion. We suggest an amendment to clarify that the higher rate for secondary and tertiary production is applicable for calendar years 1975 through 1983 and that thereafter the applicable rate for secondary or tertiary production shall be the same as that applicable to all other production. We would be glad to work with the staff in developing specific clarifying language.

Thank you for this opportunity to present our comments concerning this very important legislation.

Mr. MATSUI. Thank you. Mr. Upham.

STATEMENT OF CHESTER R. UPHAM, JR., CHAIRMAN OF THE BOARD, TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION, AUSTIN, TEX.

Mr. UPHAM. Yes. My name is Chester Upham. I appear today as chairman of the board of Texas Independent Producers & Royalty

Owners Association. We represent 5,200 members who operate in or have oil and gas interests in Texas and I am going to address my time to our opposition to the technical amendment of H.R. 6056 which amends the definition of crude oil.

In opposing this definitional change we do not wish to imply that producers who argue that the windfall profits tax was originally intended only to apply to condensate from oil wells are in error. There are substantial arguments in support of this contention based in large part on definitions in the act that reference oil wells as being the only wells subject to such taxation.

What I am opposed to is the broad authority that is evidently asked for in this amendment. On page 19 of the description of the bill that was furnished today, I find the words:

> Thus, condensate that could normally be recovered by mechanical separation will be taxed when removed from the premises, even though it is not in fact recovered from the natural gas stream. It is anticipated that Treasury will describe in regulations the circumstances under which the amount of condensate actually received prior to the application of post-separation recovery processes such as absorption or adsorption may be used to determine the amount of condensate that should have been treated as recoverable.

This would leave a vague and very arbitrary area for the IRS to make these regulations. There are generally three methods by which gas and gas condensate are accounted for at the wellhead. At the wellhead or no later than the lease, a transaction occurs. Perhaps the producer owns the gas after it leaves the leasehold, but in almost every case an accounting has to be made to the royalty owners for their proportional royalty of both the gas and the condensate and the State's severance taxes and, according to this proposal, the windfall profit tax.

In our prepared statement I have placed analyses of several different materials. Generally, in a gas condensate separation method the gas is measured and goes on to a pipeline. The condensate is removed and put into a tank, and according to a recent analysis we made on one of our wells, about 90 percent of the wellhead gas stream remains vapor.

In another operation we operated, we took the condensate and measured it through a reader and reinjected it into the pipeline and let it flow through lines to the gasoline plants or processing facilities. In that case, additional condensation diluted the original gas volume by approximately 30 percent.

When gas comes out of the well you have a saturated stream similar to the situation we had this morning where you have fog and some fog is turning into dew, and I believe first, condensate separation at the wellhead, as is conventionally accomplished, or second, measurement at the wellhead either through a metering device or a periodic wellhead test which is provided for in the Railroad Commission of Texas regulations, and three, the condensate charged back to the wells after mechanical separation at central facilities off the lease are three generally accepted proper ways of accounting for the condensate back to the producers of the wells.

And I feel that those three methods are completely adequate for taxation measurement, and there is no reason to try to say that "recoverable" should be substituted for "recovered."

Thank you.

[The statement of Mr. Upham follows:]

STATEMENT OF CHESTER R. UPHAM, JR., CHAIRMAN OF THE BOARD, TEXAS INDEPENDENT PRODUCERS & ROYALTY OWNERS ASSOCIATION, AUSTIN, TEX.

Mr. Chairman and Members of the Committee; my name is Chester R. Upham, Jr., and I am an independent petroleum producer residing in Mineral Wells, Texas. I appear here today as Chairman of the Board of the Texas Independent Producers and Royalty Owners Association (TIPRO). Our Association has 5,200 members who operate in or have an oil or gas interest in Texas; many of them have gas wells that produce condensate derived from the full gas well stream.

TIPRO opposes the proposed technical amendment of H.R. 6056 which would adjust the definition of crude oil for windfall profit tax purposes by adding the language, "[s]uch term includes condensates recoverable from natural gas (whether or not recovered before the natural gas is removed from the premises)." This amendment, in effect, would expand the current definition used under the Crude Oil Windfall Profit Tax Act (WPTA) and found in section 212.31 of the Department of Energy's crude oil regulations as of June 1, 1979, which states: "Crude oil" means a mixture of hydrocarbons that existed in liquid phase in underground reservoirs and remains liquid at atmospheric pressure after passing through surface separating facilities. "Crude oil" includes condensate recovered in associated or non-associated production by mechanical separators, whether located on the lease, at central field facilities, or at the inlet side of a gas processing plant.

In opposing the proposed definitional change, TIPRO does not wish to imply that producers who argue that the WPTA was originally intended to apply only to condensate from oil wells are in error. There are substantial arguments in support of this contention—based in large part on definitions in the Act that reference oil wells as being the only wells subject to such taxation.

Should, however, it eventually be determined that condensate production stemming from gas wells is covered by the WPTA, TIPRO strongly believes that the current definition utilized in the WPTA is the only feasible and fair approach for taxing gas well condensate. Any variation, such as that proposed, can only lead to a regulatory nightmare that would cost far more than any increase in tax revenue that might be realized.

Under normal industry operations in the field, producers who have commercially recoverable condensate in their gas well stream arrange either to separate their condensate mechanically on the lease or route their production, along with other producers, to a central separation facility located between their lease and the gas processing plant. The gas plant process is not a mechanical separation process and results only in nontaxable natural gas liquids.

If the purpose of the proposed amendment is simply aimed at those few producers who might find it economic to avoid tax on their condensate by failing to separate in mechanically before it enters the gas processing plant, then the amendment is an extremely poor solution. The overwhelming number of producers who do mechanically separate or who do not have condensate content of commercial value would be subjected to substantial expense and administrative burdens by the proposal. The word "recoverable" in the proposed amendment could lead to IRS regulations requiring constant measuring the monitoring of condensate content in the gas well stream at the lease. This in turn, could lead to unfair taxation of noncommercial or nonrecoverable hydrocarbons that remain in the gas stream sold to pipelines or ultimate consumers under provisions of the Natural Gas Policy Act.

If the purpose of the amendment is to protect against assumed tax evasion, TIPRO believes the assumption is not nearly strong enough to justify a new array of onerous tax regulation for all producers of gas well condensate. In the first place, the assumption that producers will gain by losing their commercial condensate either in the gas stream or in the processing plant versus mechanically separating it and paying the windfall tax is faulty. Contractual restrictions and natural gas liquid economics do not support the contention.

Secondly, it will be far more economic (both for the industry and for the federal government) to seek solution through normal auditing procedures under the WPTA's current definition of crude oil. If there is a condensate recovery situation in the field that does not appear to fit normal industry practice, then lease testing could be called for to determine whether commercial condensate production is not being mechanically separated and taxed. The producer, in such instances, should be offered the option of initiating mechanical separation or of falling under a new regulation that imputes his tax liability based on the commercial condensate content in his full gas stream.

For these reasons, TIRPO strongly opposes the proposed amendment to the windfall tax act definition of crude oil. The amendment constitutes a nontechnical and self-defeating expansion of the WPTA's original intent, which does not reasonably resolve the problem for which it was devised.

With the Committee's permission, I would like to discuss briefly the material presented in Appendix A relating to the composition of condensate. It might help emphasize the problems raised by the proposed amendment.

We appreciate this opportunity to be heard.

APPENDIX A.—COMPOSITION OF SELECTED HYDROCARBON MIXTURES IN MOLE PERCENTS

	Gas well condensate [1]	Scrubber condensate [2]	Unprocessed natural gas [3]	Processed natural gas [4]
Methane	0.14	0.04	70.36	89.20
Ethane	.10	.54	7.66	7.77
Carbon dioxide	.0	0	.41	.49
Propane	.54	6.60	5.43	2.49
Isobutane	.42	2.32	.76	.04
Normal butane	1.89	8.26	1.74	0
Isopentane	2.79	6.53	.69	0
Normal pentane	4.46	8.73	.88	0
Hexanes and heavier	89.66	66.99	12.05	0

[1] Condensate sample, Apr. 22, 1982, Upham Oil & Gas Co., Moody-Atkinson Unit Well No. 1, Boonesville (Bend Cong. Gas) Field, Wise County, Tex.

[2] Scrubber Condensate sample, Apr. 22, 1982, Upham Gasolene Plant, Various Fields, Wise County, Tex.

[3] Unprocessed natural gas sample, Apr. 22, 1982, Upham Gasolene Plant, Wise County, Tex.

[4] Processed natural gas sample, Apr. 22, 1982, Upham Gasolene Plant, Wise County, Tex.

Mr. MATSUI. Thank you very much, Mr. Upham. Mr. Watson.

STATEMENT OF JOHN E. WATSON, SENIOR VICE PRESIDENT, MITCHELL ENERGY CORP.

Mr. WATSON. Thank you. Mr. Chairman, members of the committee:

I am John E. Watson and I am here representing Mitchell Energy Corp. Mitchell Energy Corp. is a large independent producer of oil and natural gas. We are also a natural gas processor and we operate intrastate natural gas pipelines.

I appreciate the opportunity to discuss the revision to the definition of crude oil found on page 56, lines 7 through 11, of H.R. 6056, because if it is passed this amendment could substantially impact all producers, royalty owners, transporters, and processors of natural gas.

Before proceeding, I would like to state for the record that it is our position, and has been our position from the inception of the Crude Oil Windfall Profit Tax Act of 1980, that the definition of "taxable crude oil" includes all oil or condensate produced from oil wells only, and that condensate produced from natural gas wells is not "taxable crude oil" under the act. I am submitting our arguments in this regard for the record, as exhibit I, and will not go into them at this time.

I might say, however, that even though we do not believe that condensate is covered, however, as a protective measure we are paying the tax on the condensate which has been removed by or for our account.

The change in the definition of crude oil to include natural gas condensate, as proposed by H.R. 6056, is not a technical amendment. It is my understanding, as has been brought out today, that the original $227 billion revenue projections of both the House and the Senate never contained revenues attributable to the taxation of gas well condensate. Consequently, their addition to the Windfall Profit Tax Act by the language contained in this bill will not be technical in nature, but will be an additional excise tax on natural gas producers disguised as a technical amendment.

Contrary to this fact, and contrary to the definition of "taxable crude oil" contained in the Windfall Profit Tax Act, the IRS has taken the position that all condensate which is "removed from the premises" of a natural gas producing property is subject to windfall profit tax. Assuming for purposes of this statement that condensate either removed or sold on behalf of an interest owner in a natural gas producing property is subject to windfall profit taxes, then the redefinition of crude oil found on page 56, lines 7 through 11 of this Technical Corrections Act will create an administrative nightmare for the producers, pipelines, and processors of natural gas. It will also impose an undue administrative burden on millions of small economic interest owners throughout the United States, while collecting very little additional windfall profit tax.

Even if condensate from gas wells were covered by the act, there are very important reasons why only condensate recovered by mechanical separation by or for the producer should be subject to the tax. Natural gas producers should not be taxed for any condensate which is not recovered on or for their behalf.

The redefinition of crude oil contained in this bill would impose a potential tax burden on natural gas producers for condensate which is not recovered by or for them. This would not only impose a potential tax burden on natural gas producers which exceeds the revenues received from this condensate, but also will create additional paperwork burden, the cost of which alone could exceed the revenues received by the producers from this condensate.

This unfair and hopefully unintended result occurs for two basic reasons:

First, statistics from the Texas Railroad Commission for the years 1980 and 1981 show that gas wells on average produce very few barrels of condensate. In fact, in both years the total number of barrels of condensate produced per day divided by the total number of wells which produced natural gas yields an average condensate production of 0.65 barrels per well per day.

Second, producers of natural gas are producing and selling natural gas, not crude oil. Consequently, there are instances where condensate may be recovered many miles from the lease, not by or for the account of the gas producer, but by the pipeline or plant processor in conjunction with pipeline or processing operations.

This means that very little, if any, additional tax would be due on this condensate because the windfall profit tax is imposed on the "producer" of "taxable crude oil." Even if the definition of taxable "crude oil" is amended to include this condensate, the "producer" still receives little or no "windfall profit" from its sale. Therefore, the amendment as proposed would only create an enormous administrative burden.

This is because: One, in many instances the proper windfall profit tax tier or gas well condensate would be difficult or impossible to ascertain;

Two, natural gas pipelines and natural gas processors might technically become first purchasers of "taxable crude oil"; and

Three, millions of small interest owners, royalty owners, would have to keep withholding, depositing, and refund or credit records. They would also have to file independent producer certificates, royalty owner exemption certificates, and windfall profit tax returns.

Natural gas pipelines sometimes recover condensate which forms in their pipelines as drip and normally cannot identify the natural gas property or producer from whence it may have been produced. This condensate most likely never occurred as a liquid in the reservoir and is not "removed from the premises" as condensate attributable to producers.

In its present form the amendment would redefine crude oil in such a way as to make natural gas pipelines and processors "first purchasers" of "taxable crude oil." Not only would natural gas producers be subject to the paperwork burdens attendant to withholding, depositing, and reporting windfall profit tax, but a similar avalanche of paperwork would befall the natural gas pipelines and natural gas processors of this country.

Additionally, the imposition of recordkeeping, filing, and certification requirements will be placed on literally millions of private citizens who are small "economic interest" owners, royalty owners, in the natural gas wells of this country. Again, all for very little, if any, additional tax revenues.

Surely this result could not have been intended by this committee.

I might also say, I think earlier in the hearings today it has been accurately stated that there is a sufficient amount of doubt or misunderstanding as to whether or not there was an intent to cover gas well condensate by the committee and by the Congress and by the Senate. That being the case, even though we are requesting that you delete this change as proposed by this bill, if you do feel that an amendment is necessary and if you do intend to cover gas well condensate, then I would ask that you consider the change prospective only.

Thank you for the opportunity to appear here today and speak to this issue.

[Attachments to the prepared statement follow:]

Exhibit I.—Treatment of Gas Well Condensate Under the Winfall Profit Tax Act

I. BACKGROUND

Condensate is the liquid from an oil or gas well which is in liquid form in the reservoir or condenses from natural gas at the surface and is recovered in mechanical separators generally located on the lease, at central field facilites, or at the inlet side of natural gas processing plants. It is derived from natural gas, and natural gas may be produced from an oil well ("associated" production) or from a gas well where there is no oil production ("non-associated" production). Condensate from a gas well is often referred to as gas well condensate.

II. THE WINDFALL PROFIT TAX ACT EXCLUDES GAS WELL CONDENSATE

The Windfall Profit Tax Act (WPTA) defines "taxable crude oil" as all "crude oil" (as defined by DOE regulations) which is produced from an oil well located in the United States or a possession of the United States.

Specifically, Section 101 of the WPTA amends the Internal Revenue Code of 1954 (I.R.C.) and imposes on "producers" an excise tax on the "windfall profit" from "taxable crude oil" "removed from the premises". Section 4986(a) of the I.R.C. as added by Section 101 of the WPTA states: "Imposition of Tax—An excise tax is hereby imposed on the windfall profit from taxable crude oil removed from the premises during each taxable period."

"Taxable crude oil" is defined in Section 4991 of the WPTA, which states in pertinent part: "Taxable Crude Oil—For purposes of this chapter, the term "taxable crude oil" means all domestic crude oil other than exempt oil."

While the phrase "domestic crude oil" is not defined in the statute, the terms "domestic" and "crude oil" are defined individually. The term "crude oil" is broadly defined; it is set forth in Section 4996(b)(1) of the I.R.C. (as added by Section 101 of the WPTA) which states: "Crude Oil—The term "crude oil" has the meaning given to such term by the June 1979 energy regulations."

The energy regulations define "crude oil" in 10 C.F.R. Part 212, Section 212.31, as: "Crude Oil" means a mixture of hydrocarbons that existed in liquid phase in underground reservoirs and remains liquid at atmospheric pressure after passing through surface separating facilities. "Crude oil" includes condensate recovered in associated or non-associated production by mechanical separators whether located on the lease, at central field facilites, or at the inlet side of a gas processing plant."

By operation of the DOE's energy regulations, all condensate is deemed to be crude oil, whether from a gas well or an oil well.

In the Windfall Profit Tax Act, however, the term "domestic" narrows the definition of crude oil. Section 4996(b)(3) of the I.R.C. as added by Section 101 of the WPTA states: "Domestic—The term domestic, when used with respect to crude oil, means crude oil produced from an oil well located in the United States or in a possession of the United States.

Thus, under the express provisions of the statute, the term "taxable crude oil" makes it clear that not all "crude oil" is taxable; rather it is only "domestic" "crude oil" that is taxable. And the definition of "domestic" makes it clear that only crude oil "produced from an oil well" is taxable. Condensate produced from a gas well is not taxable.

This express limitation in the definition of "domestic" is to be contrasted with an equally express inclusion of both oil and gas wells in the definition of the identical word "domestic" in the percentage depletion provisions of the I.R.C. In Section 613A of the I.R.C., which governs percentage depletion for oil and gas wells, the term "domestic" is defined in Subsection 613A(e)(3) to specifically include production from gas wells: "Domestic—The term domestic refers to production from an oil or gas well located in the United States or in a possession of the United States."

In passing the Windfall Profit Tax Act, the Congress was well aware of the broader definition of "domestic" in Section 613A of the I.R.C. The Windfall Profit Tax Act, which added Section 4992, expressly referred to Section 613A in defining an "independent producer" for purposes of the windfall profit tax, and the definitions in Subsection 613A(e) are integral to determining "independent producer" status. Similarly, Section 4995 defines "integrated oil company" and once again, the definitions in Subsection 613A(e) are integral to the definitions of "intergrated oil company". Thus, the narrow definition of "domestic" in defining "taxable crude oil" for the WPTA to include only crude oil produced from an oil well cannot be considered as inadvertent.

The Congress several times made reference to the percentage depletion statutory provisions and incorporated by reference those provisions and definitions only with respect to certain specific determinations under the Windfall Profit Tax Act. The Congress, however, did not incorporate the already extant definition of the term "domestic", but instead enacted a separate, different definition. Similarly, Congress several times made reference to the Department of Energy's regulations and incorporated some provisions by reference. See e.g., Section 4996(b)(8). The Congress, however, did not incorporate by reference the DOE's broader definition of "domestic crude oil", which includes gas well condensate: " 'Domestic crude oil' means crude oil produced in the United States or from the 'outer continental shelf' as defined in 43 U.S.C. § 1331."

Given these facts, and the imposition of the windfall profit tax on "domestic" "crude oil", it must be regarded as the intent of Congress to exclude condensate produced from natural gas wells from the operation of the tax.

Additionally, if condensate produced from gas wells was subject to the windfall profit tax, it would have imposed an administrative burden on producers, royalty owners, transporters and processors of natural gas, the cost of which, alone, would potentially exceed the tax revenues collected from this condensate.

III. LEGISLATIVE HISTORY AND REVENUE PROJECTIONS SUPPORT THE EXCLUSION OF GAS WELL CONDENSATE

There is no indication in the statute, hearings or Congressional debates that the inclusion of gas well condensate was ever considered. The absence of such a discussion is consistent with the fact that from the outset gas well condensate was excluded from the reach of the tax. Section 2 of H.R. 3919, as introduced, would have amended Section 4991(b) of the I.R.C. to add the identical definition of "domestic" included in the Windfall Profit Tax Act as finally adopted.

The Conference Report to the statute is of no assistance in determining whether gas well condensate is subject to the tax since its discussion of the term "crude oil" merely tracks the broad DOE definition, and it fails to discuss the definition of the term "domestic".

More importantly, the development and background of Section 4990, which phases out the windfall profit tax, supports the view that gas well condensate is not subject to the windfall profit tax. The revenue projection associated with this phase out provision (See H. Report No. 96-817 at 116, for the revenue projection) is based on projections of domestic crude oil production which did not include gas well condensate. Because the methodology for that revenue projection is not published, an associate from the law firm of Andrews, Kurth, Campbell and Jones contacted one of the staff persons on the Joint Committee on Taxation responsible for the preparation of the Committee's revenue estimates, and that person advised that the supply estimates used for projecting revenues under the Windfall Profit Tax Act did not include gas well condensate. In addition, one of the staff persons in the Congressional Budget Office responsible for the preparation of that office's supply estimates was contacted concerning the supply estimates provided by that office in connection with the windfall profit tax (See "The Windfall Profits Tax: A Comparative Analysis of Two Bills", Congressional Budget Office, November, 1979) and that person also advised that gas well condensate was not included in his office's supply estimates, and, the revenue projections were not based on taxing those substances. (See attached.)

Since the $227 billion revenue projections did not include tax revenues on gas well condensate, it is very persuasive evidence that the Congress never intended to tax this substance.

IV. THE COST OF THE ADMINISTRATIVE BURDEN OF TAXING GAS WELL CONDENSATE EXCEEDS THE BENEFITS

According to DOE statistics ["Petroleum Monthly Statement", EIA, DOE (for December, 1979, issued May, 1980)], the national average daily production of gas well condensate per gas well in 1978 was only 2.25 barrels per day. Even if "taxable crude oil" was redefined to include gas well condensate, much of this production is recovered by natural gas pipelines and natural gas processors who are not "producers" of "taxable crude oil", and therefore not subject to the windfall profit tax anyway. However, if "taxable crude oil" was redefined to include gas well condensate, all producers, royalty owners, transporting and processors of natural gas would be subject to a virtual avalanche of paperwork.

Producers of natural gas would have to file withholding, depositing and a myriad of reporting forms. Since natural gas pipelines and processors would technically become "first purchasers" of "taxable crude oil", they also would be subject to withholding, depositing and reporting requirements. Since many different natural gas producing properties feed into the pipeline systems of America, the reporting burden is multiplied because in many instances the proper windfall profit tax tier of gas well condensate is difficult or impossible to ascertain.

Lastly, there are millions of Americans who own small royalty interests in gas wells. If " taxable crude oil" was redefined to include condensate produced from gas wells, millions of small interest owners would now have to keep withholding, depositing, refund or credit records, file independent producer certificates, royalty owner exemption certificates, and windfall profit tax returns. All of this for approximately 2.25 barrels of condensate per well per day, most of which would not be taxable anyway.

CONCLUSION

Currently, the Crude Oil Windfall Profit Tax Act of 1980 does not tax condensate produced from natural gas wells. To do so would impose an excessive administrative burden on producers, royalty owners, transporters and processors of natural gas, while collecting very little, if any, additional windfall profit tax.

ANDREWS, KURTH, CAMPBELL & JONES,
Washington, D.C., June 13, 1980.

Re Treatment of gas well condensate under the windfall profit tax.

At our meeting on June 11, 1980, you said that it would be helpful to know the results of our investigation into how the revenue estimates for the Crude Oil Windfall Profits Tax Act of 1980 ("Windfall Profit Tax") were compiled. Michael F. Butler requested that I provide you with a description of my research efforts.

As we discussed, perhaps the most compelling policy consideration concerns the development and background of Section 4990, which phases out the Windfall Profit Tax. That section supports the view that gas well condensate is not subject to the Windfall Profit Tax. The revenue projection associated with this phaseout provision (See H. Report No. 96-817, at 116, for the revenue projection) is based on projections of domestic crude oil production which did not include gas well condensate. Because the methodology for that revenue projection is not published, I contacted Mr. Linden C. Smith, Economist, Joint Committee on Taxation on May 19, 1980. Mr. Smith informed me that supply projections had been provided to him by the Department of Energy (DOE) through the Department of Treasury, and that the DOE had received those numbers from a consultant, Mr. Steve Muzzo of ICF, Inc. As we understand from Mr. Smith, the supply projections provided by Mr. Muzzo served as the basis for all revenue estimates used by the Joint Committee on Taxation. Mr. Smith stated that the supply estimates used for projecting revenues under the Windfall Profit Tax did not include gas well condensate. I also contacted Mr. Muzzo who stated that supply estimates provided to the DOE, which were used in estimating Windfall Profit Tax revenues, did not include gas well condensate.

On May 19, 1980, I sent letters to Mr. Muzzo and Mr. Smith confirming those conservations. On June 2, 1980, Mr. Smith called me to state that he had spoken with Mr. Eugene Glass of the DOE and that Mr. Glass stated that all supply estimates "should have" included gas well condensate. Mr. Smith did agree to contact Mr. Muzzo regarding the estimates provided by ICF, Inc. On June 3, 1980, I spoke with Mr. Glass who stated that his office provided historical production figures which did include gas well condensate, but that his office did not provide any estimates of future production. On June 3, 1980, I contacted Mr. Muzzo who repeated the substance of the May 19, 1980, conversation—he provided supply estimates which were used for Windfall Profit Tax purposes and those estimates did not include gas well condensate. Mr. Muzzo agreed to confirm that information by letter, but we have not yet received it. On June 3, 1980, Mr. Smith contacted me to inform me that he now was sure that the supply estimates from which the revenue estimates were computed did not include gas well condensate. Mr. Smith repeated that these estimates were based on the figures provided by Mr. Muzzo and that no adjustments were made to Mr. Muzzo's figures by DOE, Treasury, or the Joint Committee to add gas well condensate to the suppy projections used to estimate Windfall Profit Tax revenues.

In addition, Mr. Lawrence H. Oppenheimer of the Congressional Budget Office was contacted concerning the supply estimates provided by that office in connection with Windfall Profit Tax. See "The Windfall Profits Tax: A Comparative Analysis of Two Bills," Congressional Budget Office (November 1979). Mr. Oppenheimer also stated that gas well condensate was not included in his office's supply estimates, and, therefore, the revenue projections were not based on taxing those substances.

Incidentally, Mr. Smith, Mr. Oppenheimer and Mr. Muzzo also have advised me that the supply estimates did not include so-called pipeline condensate as well.

Sincerely,

JAMES R. MYERS.

Mr. ANTHONY. Thank you, Mr. Watson.

Are there questions of the panel from members of the committee? Mr. Archer?

Mr. ARCHER. Thank you, Mr. Chairman.

Mr. Upham, I know there has been some concern on the part of the staff and perhaps some members of the committee that if you restrict the definition of condensates there might be—that is, in lieu of a broader recoverable type definition such as they put in this bill—that there might be the possibility of someone making an end run around this whole process and getting these condensates out and pay no windfall profit tax on them.

As a practical matter, from your experience in the business would you like to comment on that?

Mr. **Upham**. First of all, we do not advocate tax evasion, and there is no way I know that you can accurately measure gas and condensate without previously separating them. So if you separate them and then measure them and then recombine them, but do not report the measurement of the condensate, you are evading the tax consequences.

Measurement is one of the operations that must be done. In almost every case there is a compression operation, and in the compression operation natural gas and condensate cannot go through the compressor together. The condensate has to be removed before the gas goes through the compressor. Liquids in the gas stream would damage the compressor.

As far as a gasoline plant or a gas processing facility is concerned, whether it is an absorption facility, adsorption facility, a refrigeration facility or a turbo-expander, liquids must be removed prior to the entry into these plants. Now, that does not mean they cannot be piped around, but I think it is an illegal operation if it is the intent to tax them as producers. We are talking about producers of condensate.

Mr. **Archer**. So for effective control and assurance that the tax is paid where it should be paid, if the Congress did intend to tax condensates, it would be necessary to go to the term "recoverable," which would leave all these loose ends, the drip situation and all of that as possible administrative nightmares.

Mr. **Upham**. The word "recovered" is completely adequate. The word "recoverable" is something which tends to be something which might or might not be recovered, and this does not reflect the actual situation in the field.

Mr. **Archer**. And did I understand you correctly that if you tried to put wet gas, that is gas where you have not separated the condensates, through a compressor that it would destroy your compressor?

Mr. **Upham**. It would damage or destroy the compressor at that time and would cause necessary repairs thereafter.

Mr. **Archer**. Thank you very much.

Mr. **Pickle**. Mr. Chairman.

Mr. **Anthony**. Mr. Pickle.

Mr. **Pickle**. I think the intent of the measure was to establish the fact that you have a tax on crude oil, and yet the proposed definition of crude oil does cause you some problems. If you kept it in as proposed, what changes would it force the producers to make in their operations out in the field?

Would it place a burden on the producers if we kept it like it is in the technical corrections bill?

Mr. **Upham**. Like the law is today or as proposed?

Mr. **Pickle**. As proposed.

Mr. **Upham**. Well, as proposed it would give the Treasury the opportunity to say that this is the level of condensates that should have been recovered and therefore, because you didn't recover them at the well, you should have recovered them later on.

At the wellhead we make an accounting. We have a liquid-gas separation and the gas is then sold under NGPA-regulated prices on a Btu basis, and that gas goes off in that direction. And if subsequently an additional amount of liquids should be expected to be condensed from there and if the IRS auditing agent said that that liquid should have been taxed, that operator would be taxed for something he sold under regulated natural gas prices, which is certainly not the intent of the act.

Mr. PICKLE. The definition in the technical bill would require the windfall tax to be paid on condensate that is recoverable, not just that which is recovered. And what you want to do is say it applies to that which is recovered. I assume that is what you are trying to drive at; is it not?

Mr. UPHAM. Mr. Pickle, when the gas comes out of the well and goes into the separator, you have a saturated condition. The gas is saturated and a change in temperature or pressure would cause more or less condensables. So at some time you have to say, this is the liquid and this is the gas.

Later on you may have some of the liquid back into the gas or you may have gas condense into the liquid. But at a point—and the proper point is at the leasehold facilities—if the amounts of liquids are so small and so insignificant that you do not measure them or attribute them back to the well, then the present law definition requires that they be accounted for at a later scrubber, at a compressor scrubber or at a process plant in the scrubber.

Under no circumstances should I feel that a quota be made or an estimate be made of the recoverable condensate and then the producer be expecting to use that formula. He should use what is actually the practice.

Mr. PICKLE. Again, let me try to see if I can make this clear. I started off by asking what kind of a burden the proposed definition would cause on you. I guess if you were to determine what condensate would be recoverable, that would require testing that might be expensive, and really not very accurate either, I presume?

Mr. UPHAM. It would be arbitrary. In other words, if we had an arbitrary standard that said a certain percent of the hexanes and heavier, a certain percent of the pentanes would be recoverable under this definition, then we would be required to have some type of a sample analysis, a temperature and pressure monitoring, and some computation to determine what that is.

And what we have at the present time are oilfield separation facilities which actually give us the data we need to determine what was actually recovered. The additional monitoring equipment, the analysis equipment, and the equipment it would take to project what would be recoverable would be very burdensome, very expensive and inaccurate.

Mr. PICKLE. I hope we can prevent that.

Thank you for your testimony.

Mr. ARCHER. Mr. Matsui.

Mr. MATSUI. Thank you, Mr. Chairman.

I would like to ask Mr. Parkin a question if I may. It is my understanding, Mr. Parkin, that because of the deficiencies in the law at this time, California is the only State in the country and government entity for which the windfall profit tax is applicable; is that right?

Mr. **Parkin**. That is right, we are the only governmental entity with a net profits arrangement, yes.

Mr. **Matsui**. And the technical amendment as set forth in the legislation at this time, that is to make the changes prospective from March 1982, would not help California because it works on a net profits basis in terms of its contractual relationship with the oil companies, whereas the basis under the current law is that it would have to be a fixed amount; is that correct?

Mr. **Parkin**. That is correct.

Mr. **Matsui**. And a great amount of California's profits, that is the benefits obtained from our oil drilling go to the university system, and this is required under State law.

Mr. **Parkin** [nods affirmatively]. Under State law it is allocated to the capital outlays for higher education.

Mr. **Matsui**. Just for the record, Mr. Chairman, I would like to state that Mr. Rousselot, Mr. Stark, and certainly myself plan to offer an amendment to correct this situation and carry out the intent of your testimony at this time.

Mr. **Parkin**. Thank you, Mr. Matsui.

Mr. **Matsui**. I yield back, Mr. Chairman.

Mr. **Anthony**. Mr. Hance.

Mr. **Hance**. I have one quick question to Mr. Scoggins and also to Mr. Upham. In Mr. Watson's testimony he states that your position has been from the inception of the act that the definition of taxable crude oil includes all oil or condensate produced from oil wells only. Do you all agree with that position, that it should not include anything produced from a gas well because the gas is under price controls?

Mr. **Scoggins**. We would not disagree with that position. There has been considerable controversy over that point.

Mr. **Upham**. Mr. Hance, we feel the same way. We have members who feel very strongly that it was meant to be oil condensate only. But some producers are agreeing that condensate might be under it and they are paying the windfall profit tax accordingly.

Mr. **Hance**. Thank you very much.

Thank you.

Mr. **Archer**. Do any other members of the committee have a question?

[No response.]

Mr. **Archer**. We thank you for your testimony. I hope Treasury is listening to the testimony when it concerns windfall profits as far as the complication, the rules and the regulations.

I have probably had more complaints brought to my attention in the last three years about the operations of the tax we passed and the complexity of it and the fact that many of the people who bear the burden of that tax have no expertise and the amounts of money involved are not sufficient to go out and hire the technical expertise that it takes. It just outweighs one another.

So hopefully, with some of the support you have already heard expressed from this committee, we can bring a little sense and balance to that.

And we thank you for coming.

Mr. **Anthony**. The next witnesses will be: Donald C. Lubick, counsel, Talisman Fund; and the Heinold Commodities Corp., represented by Frank V. Battle, counsel. It is a joint appearance. Welcome before the committee. Mr. Lubick.

STATEMENT OF DONALD C. LUBICK, COUNSEL, TALISMAN FUND, AND FRANK V. BATTLE, COUNSEL, HEINOLD COMMODITIES CORP.

Mr. LUBICK. Thank you, Mr. Chairman.

We have a fairly short statement we would ask to be included into the record, together with some draft language of a suggested amendment to the Technical Corrections Act. And if I may, I will just take a few seconds to summarize our proposal.

Essentially, it is a proposal to permit the election by taxpayers to treat their investments in foreign currency contracts, contracts for the delivery at a future time of certain foreign currencies, in the same manner as similar contracts traded on a regulated exchange which are covered under the Economic Recovery Tax Act as regulated futures contracts.

Those contracts are taxed on the so-called mark to market basis. An annual evaluation is made at the end of each year and gain or loss is recognized under the statute.

The International monetary market, which is the regulated exchange on which futures contracts and currency are traded, is a relatively recently formed exchange. It does not permit the large volume that is available on contracts on the interbank market. And before the enactment of the Economic Recovery Tax Act, it was recognized in the scheme of taxation that the contracts essentially were economically leading to the same consequences. They were taxed the same.

At the time the new system of taxation was put in for regulated futures contracts, there was not time at the last moment to study the technical aspects of extending the same treatment to forward contracts.

The staff requested that we come back immediately following the enactment of the statute, and we have been working with them over several months. I believe it is fair to say that it has been concluded that it is appropriate that these contracts ought to be taxed on the same basis, and that is the gist of the amendment.

The Treasury Department has indicated to us that it is satisfied that this method of taxation could not be the subject of abuse or misuse. In fact, it would clear up a number of uncertainties left as a result of the legislation.

We have suggested that it is appropriate as a technical correction because it is necessary, first, to conform the treatment of contracts that have identical economic consequences in the same manner. It would also clear up a considerable amount of uncertainty that would otherwise exist in the straddle area with respect to the definition.

It would in effect provide for current taxation of all transactions in this type of investment. Essentially, the matter comes within a number of past precedents of previous technical corrections acts to provide conforming treatment and to remove uncertainty. On that basis and on the basis of our discussions with the relevant staffs, we believe it would be appropriate to amend the act to include the suggested language.

[The prepared statement of Messrs. Lubick and Battle follows:]

STATEMENT OF DONALD C. LUBICK AND FRANK V. BATTLE

Mr. Chairman and members of the committee, thank you for permitting us to appear before the Committee today to testify in favor of an amendment to H.R. 6056, the Technical Corrections Act of 1982. The amendment we propose would add a new Section 1256(g) to the Internal Revenue Code to permit an election to treat foreign currency contracts in the same manner as regulated future contracts. Suggested statutory language is attached to our statement.

Our statement will deal with two aspects of the proposed amendment. First is its justification on the merits and second is its appropriateness as a technical correction amendment to the 1981 Act (ERTA).

FOREIGN CURRENCY CONTRACTS

Title V of ERTA eliminated so-called tax straddles by two general approaches. Section 1256 treats regulated futures contracts (RFCs) as if they were sold for their fair market value in the last day of a taxpayer's year and includes gain or loss from such sales in taxable income. For positions other than RFCs, Section 1092 defers deduction of a loss realized from one "leg" of a straddle to the extent the taxpayer has unrealized gain from another "leg." Application of the loss deferral rule of Section 1092 requires identification of positions constituting a straddle, whereas valuation under Section 1256 does not. By eliminating the necessity of attempting to match positions Section 1256 provides an administratively simpler method of taxation, avoids disputes between taxpayers and the Internal Revenue Service and allows certainty of the tax consequence of trading commodity contracts.

Taxpayers trade in foreign currencies through RFCs and foreign currency contracts. RFCs in major currency are traded on the International Monetary Market, and foreign currency contracts are made with any of a number of commercial banks which make up the large interbank market. Prior to enactment of ERTA taxpayers were indifferent as to which market was used. For example, trading advisors to large partnerships of individual investors often placed orders for foreign currency transactions with their brokers without knowing whether the contract would be made on the IMM or the interbank market.

Because foreign curreníy contracts are made in the interbank market, rather than on a regulated exchange, Section 1256(a) does not apply to them. However, the economic consequence to the investor in foreign currency contracts is the same as if he had invested in RFCs in foreign currencies. Also, the difficulty in identifying which positions in foreign currencies constitute straddles to which Section 1092 applies has created uncertainty of tax results particularly for large volume traders. Thus, to provide parity of taxation between contracts having equal economic consequences to taxpayers and since it is usually impossible to match the numerous positions held by taxpayers who trade bank forward contracts, the amendment permits taxpayers to elect to apply the principles of Section 1256 to foreign currency contracts in those currencies which are also traded on U.S. exchanges. The election under Section 1256(g) with respect to Section 1256(a) would not apply to a foreign currency contract which is a part of a hedging transaction under Section 1256(e).

Once made, the election is binding upon the taxpayer for future years. Annual valuation will be based upon generally available market quotations currently furnished to taxpayers by their brokerage firms or other sufficient evidence provided by the taxpayer. No additional record keeping or reporting by banks will be required as a result of the amendment. The amendment covers all contracts (except in hedging transactions) transacted through the interbank system even though the taxpayer may enter the transactions through a broker-dealer or a futures commission merchant and may not be in privity of contract with the bank which executes the order. The Secretary is given broad discretion to promulgate regulations under which terms not generally included in foreign currency contracts can be disregarded in valuing contracts held by taxpayers who elect this provision. In addition, the Secretary may deny use of the provision to a taxpayer unless related taxpayers and flow through entities in which he has an interest also elect the provision.

The revenue effect from extension of parity of treatment to the two forms of contract with like economic consequence would be nominal. If the proposal is not adopted, the affected investors would simply not trade in the interbank market. Instead, they would trade to the extent its limited volume permits on the IMM or forego trading in this commodity entirely. Because Section 1256 would accelerate and encourage payment of taxes, it is entirely possible that this amendment would entail a revenue pickup.

THE AMENDMENT AS A TECHNICAL CORRECTION

The basis of the amendment is to reinstate the same tax consequences for transactions with identical economic consequences. Where the selection of one of two legal vehicles to effectuate an economic investment is a matter of indifference on economic grounds, the tax consequences ought not to differ between their treatment. The amendment would simply conform the treatment of economically equivalent contracts in the interbank market to that prescribed for contracts on the recognized commodity exchange. In fact, comparable treatment is essential to avoid uncertainty as a result of the ERTA rules and to assure compliance with the ERTA objective of taxation in this area of commodity trading by precluding manipulation of offsetting positions in the two markets.

Assuring identical treatment for comparable transactions has been one of the most frequent criteria for inclusion in past technical corrections acts. For example, in the 1978 Act a technical correction of the 1976 Act was needed to eliminate differential tax treatment for historic structures depending on whether they were in federally deregulated historic districts or state or locally designated historic districts. An amendment was made to treat the requirements for a condominium management association for tax exemption the same as a residential real estate management association. Again, as here, the entities were economically equivalent, which called for parity of tax treatment.

Without belaboring the point by other illustrations, making a tax enactment apply equal treatment to both forms of currency contracts is well within past limits of technical corrections. A properly designed approach to currency contracts would have included both types of contracts.

Another criterion for technical correction has been the prevention of confusion caused by an amendment. The applicability of the balanced position rules for RFC straddles are indeed difficult to apply in this area. Are contracts in different currencies balanced positions? The amendment would permit eliminating this course of confusion and controversy.

Actually, the problem of differing treatment for interbank contracts and RFCs was brought to the attention of the staff at the eve of passage of ERTA under the contention that proper technical conception of the current taxation rules for RFCs should, as a technical matter, embrace interbank contracts as well. Unfortunately, time did not permit on-the-spot evaluation of the proposition for technical pitfalls. Since that time all the staffs involved have studied the situation and, we do not believe, disagree with the result. Hence, technical correction is appropriate to make the statutory scheme read as it would have originally, if time had permitted the necessary evaluation.

We urge the adoption of the draft amendment to H.R. 6056.

DRAFT OF PROPOSED AMENDMENT

1. The following shall be added to section 1256 as a new subsection (g):

(g) ELECTION WITH RESPECT TO FOREIGN CURRENCY CONTRACTS—

(1) ELECTION.—A taxpayer may elect to have foreign currency contracts treated, under regulations prescribed by the Secretary, for purposes of this section in the same manner as regulated futures contracts.

(2) TIME AND MANNER.—An election to have paragraph (1) apply to foreign currency contracts shall be made at such time and in such manner as the Secretary may by regulation prescibe.

(3) ELECTION REVOCABLE ONLY WITH CONSENT.—An election under paragraph (1) shall apply to the taxpayer's taxable year for which made and to all subsequent taxable years, unless the Secretary consents to a revocation of such election.

(4) FOREIGN CURRENCY CONTRACT.—For purposes of this subsection, the term "foreign currency contract" means a contract (A) which by its terms requires delivery of foreign currency if it is a currency in which positions are also traded through regulated futures contracts and (B) which is traded in the interbank market.

(5) SPECIAL RULE.—The Secretary may prescribe regulations under which the election provided in paragraph (1) shall not apply to a foreign currency contract unless it applies to all foreign currency contracts that the taxpayer is treated as holding by reason of section 1092 (d)(3) and may disregard any terms in a contract held by an

electing taxpayer that the Secretary determines preclude readily ascertainable valuation.

2. The effective date of the provisions of this amendment shall be as provided in Section 508 and 509 of the Economic Recovery Tax Act of 1981.

Mr. Anthony. Mr. Battle, do you have additional comments?

Mr. Battle. No, I have nothing to add.

Mr. Anthony. Mr. Martin, it looks like we have waited them all out. Do you have any additional questions or comments?

Mr. Martin. No. I welcome Mr. Lubick back, but I have no additional questions or comments.

Mr. Anthony. Well, our thanks to you for your presentation. I am sure staff will educate members of the committee as soon as they have had a chance to go through it. You caught my attention just with the complexity of the testimony.

Our next witness is Paul W. Oosterhuis, counsel representing American Electrics Association, Semiconductor Industry Association, Computer & Business Equipment Manufacturers Association, and Scientific Apparatus Makers Association.

STATEMENT OF PAUL OOSTERHUIS, COUNSEL, AMERICAN ELECTRONICS ASSOCIATION, SEMICONDUCTOR INDUSTRY ASSOCIATION, COMPUTER & BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION, AND SCIENTIFIC APPARATUS MAKERS ASSOCIATION

Mr. Oosterhuis. Good afternoon, Mr. Chairman. My name is Paul Oosterhuis. I am here today on behalf of the American Electronics Association, the Computer & Business Equipment Manufacturers Association, the Scientific Apparatus Makers Association, and the Semiconductor Industry Association.

These four associations were primarily among the private groups which last year supported congressional efforts to enact the R. & D. tax credits. I am here today to discuss one proposed amendment with respect to that credit.

As enacted last year, the R. & D. credit applies to specified types of direct R. & D. expenditures. These expenditures include wages and salaries of R. & D. personnel, supplies used in R. & D. activities, and R. & D. equipment leasing costs. Now on H.R. 6056 it is proposed that R. & D. equipment leasing expenses be eliminated with only a limited exception for certain computer time-sharing costs.

By any reasonable definition of technical amendment, this proposal to virtually eliminate R. & D. equipment leasing expenses under the credit is not a technical amendment. In considering the R. & D. credit last year, this committee discussed and specifically voted to include all direct R. & D. expenditures, which by definition includes R. & D. equipment leasing expenses, for purposes of the credit.

In addition, in its deliberations the full Senate approved an amendment which specifically made eligible for the credit all leasing expenditures with respect to any computers used in research activities. In no way can these records be read to encompass a congressional intent to exclude leasing expenses for purposes of the credit.

Notwithstanding the above legislative history, it is our understanding from the staff of this committee that the provision was included in the bill because of concerns that the leasing provisions could be utilized by companies to lease identical equipment back and forth with other companies on identical terms, what we might call swap lease transactions.

In my own practice and through my work with the four associations mentioned above, I can honestly say that I know of no case where any two companies have entered into such a swap lease transaction. Moreover, even if such transactions do exist, the IRS arguably has ample authority to deny any company an R. & D. tax credit on lease payments pursuant to such an agreement, since the agreement would likely constitute a sham transaction.

Further, if Treasury or this committee's staff believe existing law is not sufficient to prevent such swap lease transactions, the technical corrections bill could have accomplished that purpose through a much more limited amendment, or even through a statement in the legislative history of the bill. Such an amendment or statement would certainly have been unobjectionable to the associations I represent.

But the proposed amendment in H.R. 6056 goes substantially beyond eliminating any potential abuse. Indeed, it R. & D. lease expenses even where the leases are undertaken purely for business purposes and without regard to tax consequences.

Let me make clear, the only type of leases we are talking about here are true leases. The Treasury Department has already determined that so-called safe harbor leases of R. & D. equipment will not qualify for the R. & D. credit. Thus only transactions which are subject to the IRS rather strict leasing rules are eligible for the credit under the present law.

In our discussions with this committee's staff, a concern was indicated that permitting the credit for any lease expenditures might create an incentive for companies to lease rather than purchase their R. & D. equipment. Such a concern may or may not be reasonable. However, the concern reflects a matter of congressional policy and certainly not a matter of mere technical amendment.

Indeed, the question of whether the R. & D. credit provides companies with a sufficient incentive to lease rather than own their R. & D. equipment cannot easily be answered. As Congress well understood last year when it enacted the safe harbor lease provisions, any company entering into a true lease transaction must transfer a significant, if not substantial, portion of the tax benefits associated with the leased equipment to the lessor.

Thus, any company which enters into a true lease of its R. & D. equipment must inevitably give up a substantial portion of its ACRS benefits associated with that equipment to the equipment lessor. If this fact is taken into account, it is not at all certain whether permitting R. & D. equipment leasing expenses to qualify for the R. & D. credit gives enough incentive to lease such equipment rather than own it in any particular case.

For this reason and others discussed more fully in my full statement, the merits of including R. & D. equipment lease expenses for the purposes of the R. & D. credit is not only a question of substance, but one on which strong arguments can be made in favor of including such expenses. However, we are not here today to argue that such expenses should without a doubt be eligible for the credit in all cases. Rather, we urge that any consideration of the leasing provision generally be considered separate from the technical amendments bill.

The R. & D. credit is just beginning to be implemented by taxpayers across the country. Over the past 6 months, the associations I represent have actively been working with their members to help them understand and apply the credit in ways that encourage increases in research in this country.

In that process, many of their members have made numerous suggestions for ways to improve and expand the credit. Thus we suggest that if serious concerns continue to exist regarding R. & D. equipment leasing expenses these be made the subject of a separate hearing, which hearing could also include a discussion not only of areas relating to lease expenses, but to issues involving possible improvements in the credit as well.

Thank you very much.

[The prepared statement of Mr. Oosterhuis follows:]

STATEMENT OF PAUL W. OOSTERHUIS, ON BEHALF OF AMERICAN ELECTRONICS ASSOCIATION, COMPUTER & BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION, SCIENTIFIC APPARATUS MAKERS ASSOCIATION, AND SEMICONDUCTOR INDUSTRY ASSOCIATION

SUMMARY

The proposal in H.R. 6056 to exclude most R&D equipment leasing costs from eligibility under the R&D credit should be removed from this bill for the following reasons:

1. The proposal as drafted clearly goes beyond the requirements of any technical amendment.
2. The potential abuses from so-called "swap leases" can be eliminated through a much more limited amendment.
3. Strong arguments can be made in favor of the inclusion of other lease expenses for purposes of the credit.
4. The merits of including leasing expenses generally for purposes of the credit should be considered in a separate hearing, at which time improvements in the credit in other respects can also be considered.

STATEMENT

Good afternoon, Mr. Chairman. My name is Paul Oosterhuis. I am a partner with the Washington law firm of Hogan & Hartson. I am here today representing the American Electronics Association, the Computer and Business Equipment Manufacturers Association, the Scientific Apparatus Makers Association and the Semiconductor Industry Association. These four associations were primary among the private groups which last year supported Congressional efforts to enact the R&D credit. On their behalf I am here to discuss with you one amendment included in H.R. 6056 with respect to that credit.

As enacted last year the R&D credit applies to specified types of direct expenditures relating to R&D activities. These expenditures include wages and salaries of R&D personnel, supplies used in R&D activities and expenses for the use of personal property in R&D activities (i.e., equipment leasing costs). Now in H.R. 6056 it is proposed that R&D equipment leasing expenses be eliminated from the R&D credit except in the limited circumstance of computer time-sharing where the individual purchasing the computer time is not the primary user of the computer. Neither the bill itself nor the accompanying statement in the Congressional Record indicates the rationale for this proposal.

By any reasonable definition, the proposal to virtually eliminate R&D equipment leasing expenses under the credit is not a technical amendment. In considering the R&D credit last year this Committee discussed and specifically voted to include all direct expenses, which by definition includes R&D equipment leasing expenses, for purposes of the credit. In addition, in its deliberations on the credit the full Senate approved an amendment which specifically made eligible for the credit all leasing expenses with respect to computers used in R&D activities. Thus, the records both of this Committee and of the full Senate indicate a Congressional intent to include all leasing expenses of at least some equipment for R&D credit purposes; in no way can those records be read to encompass a Congressional intent to exclude such expenses for any reason.

Notwithstanding the above legislative history of the 1981 Act, it is our understanding that the staff of this Committee included in H.R. 6056 the proposal to eliminate most lease expenses from the credit because of concerns that the leasing provision could be utilized by companies to lease identical R&D equipment back and forth with other companies on identical terms (so-called "swap lease" transactions). In my own practice and through my work with the above four associations, I can honestly say that I know of no case where two companies have entered into such swap lease transactions. Moreover, even if some such transactions do exist, the IRS arguably has ample authority to deny each company any R&D credit on lease payments since the lease transactions are likely to constitute sham transactions.

Further, if the Treasury or this Committee's staff believe existing law is not sufficient to prevent these swap lease transactions, the technical corrections bill could have included an amendment (or even a statement as part of the legislative history) to the effect that the expenses of leasing research equipment are not to be eligible for the R&D credit where the equipment is identical or substantially identical to similar equipment of the taxpayer which is leased to a third party. Such an amendment would firmly put to rest any concerns regarding possible abuses through swap leases. The amendment would be unobjectionable to the four associations I represent.

But the proposed amendment in H.R. 6056 as introduced goes substantially further than eliminating any such potential abuses. It eliminates the expenses with respect to leases of R&D equipment even where the leases are undertaken purely for business purposes and without regard to tax consequences. It should be understood that the only type of leases in question here are true leases; the Treasury Department has already made it clear that safe harbor leases of R&D equipment (i.e., where the equipment is treated as leased solely for tax purposes) will not qualify for the R&D credit. Thus, only lease transactions that are subject to the IRS's rather strict rules applicable to non-safe harbor leases are eligible for the credit. Clearly, eliminating the eligibility for the R&D credit of expenses with respect to these leases goes beyond limiting the credit's application to potentially abusive or purely tax-motivated transactions.

In our discussions with this Committee's staff, a concern was indicated that permitting the credit for any lease expenses might create an incentive for companies to lease rather than to purchase their R&D equipment. In last year's deliberations this Committee decided that the R&D credit should not be permitted for the tax attributes of owning R&D equipment (e.g., depreciation deductions) because the ACRS provision of the 1981 Act liberalized somewhat (although not very much) the depreciation deductions and investment credit applicable to those assets. However, according to staff, concern now exists that since the R&D credit is not provided for purchasing R&D equipment, allowing the credit for leasing such equipment might cause a distortion of taxpayer behavior in favor of leasing transactions.

Such a concern may or may not be reasonable. However, the concern reflects a matter of Congressional policy and not merely a matter of technical amendment. Thus, the merits of such a concern should be considered in the context of substantive legislation relating to the R&D credit rather than in the context of technical amendments.

Moreover, we should point out that even as a matter of substantive legislation the question of whether the R&D credit provides companies with an undue incentive to lease R&D equipment cannot be easily answered. As the Congress well understood last year when it enacted ACRS and the safe harbor leasing provisions which are a part of ACRS, under the IRS's prior leasing rules any company desiring to lease equipment had to transfer a substantial portion of the tax benefits associated with that equipment to the equipment lessor in order for the lease to qualify as a bona fide lease for tax purposes. Indeed, it was largely for this reason that Congress enacted the safe harbor lease provisions last year; the provisions establish a mechanism through which a larger portion of the tax benefits with respect to leased equipment can be passed on to lessees. Yet, the leases which give rise to eligible expenses under the R&D credit are, as stated before, not safe harbor leases but leases which qualify as true leases under the requirements apart from the safe harbor rules. Thus, any company which enters into such a lease of its R&D equipment must inevitably give up at least a portion of the tax benefits associated with that equipment. If this fact is taken into account, it is not necessarily certain whether permitting R&D equipment leasing expenses to qualify for the R&D credit gives a significant incentive to lease R&D equipment in any particular case. The additional benefits of the R&D credit in each case must be compared to the loss of benefits under ACRS.

The uncertain nature of any incentive to lease R&D equipment also results because the R&D credit is an incremental credit: the credit is allowed only for increases in R&D expenditures for the current year over the level of those expenditures for prior years. Thus, a company entering into a lease of R&D equipment will not as a practical matter receive the credit with respect to its costs of that particular lease in each year of the lease. Instead, because the lease will likely provide for relatively level rent payments throughout the lease term (as is required under current IRS guidelines), any R&D credit can effectively be obtained only for the first full year's expenses of that lease. If this fact is taken into account, the benefit to a taxpayer from leasing R&D equipment may indeed be less than the tax benefits of ownership of that equipment.

As the above discussion indicates, the merits of including R&D equipment lease expenses for purposes of the R&D credit is clearly a question of substance, and strong arguments can be made in favor of including such expenses under the credit. However, we are not here today to argue that such expenses should without doubt be eligible for the credit in all circumstances. Rather, we urge that any consideration of the leasing provisions generally (apart from its application to swap leases) be considered separately from this technical amendments bill.

The R&D credit is just beginning to be implemented by taxpayers across the country. Over the past six months the associations I represent today have actively been working to help their members understand and apply the credit in ways that encourage increases in R&D expenditures. In that process their members have made numerous suggestions of ways to improve and expand the credit. Thus, we suggest that if concerns exist with regard to R&D equipment leasing expenses, these concerns be made subject to a separate hearing which would include a discussion not only of issues relating to lease expenses but also of issues relating to other possibly desirable changes in the credit as well. Such a procedure would surely be more appropriate than adopting an amendment, which has a clear and substantive impact, without careful consideration in a bill intended only to undertake technical corrections.

Mr. ANTHONY. Thank you.

Although I hear your argument saying you do not particularly want to go into the substantive issue, and this is substantive in nature and not technical, could you just explain to me the harmful effects if this is included in the bill from your standpoint? What do you say will happen?

Mr. OOSTERHUIS. There are two aspects. First, companies who have engaged in leasing transactions for ordinary business reasons, which include not only companies that lease equipment that they use for the long-term in their business, but companies that lease equipment for short-term use for specific projects, would lose the credit with respect to those expenditures.

It seems to us that if the R. & D. credit is supposed to be a substantial incentive to encourage increases in research activities, there is no reason to reduce the incentive by taking away eligibility for the credit for those expenditures.

The second aspect of it to our mind is that there really are other issues that could be discussed at the same time this kind of issue is being discussed. There are a number of other types of expenditures that were not included in the credit last year—education-related expenditures of R. & D. employees, some types of nonwage benefits of employees—that could legitimately be considered in terms of whether or not it would be helpful from the point of view of expanding the credit and making it more effective at the same time a look at the merits of leasing expenditures could be considered.

So it seems to us that is the more proper forum to get into this kind of an issue.

Mr. ANTHONY. Thank you very much.

Are there any other questions from the committee?

[No response.]

Mr. ANTHONY. If not, our thanks to you.

The next witness is Robert F. Long, Daily Industries, Inc., accompanied by Dennis I. Meyer, counsel.

STATEMENT OF ROBERT F. LONG, PRESIDENT, DAILY INDUSTRIES, INC., ACCOMPANIED BY DENNIS I. MEYER, COUNSEL

Mr. LONG. Good afternoon, Mr. Chairman.

Mr. ANTHONY. Good afternoon, Mr. Long.

Mr. LONG. I have, a seven-page written statement which I would like to incorporate into the record. But if it is all right with the committee I would like to just speak from some notes I have summarizing the technical problem I am here to address.

Mr. ANTHONY. Your testimony will be accepted for the record.

Mr. LONG. My name is Robert F. Long and I am the president and chief executive officer of Daily Industries, a trucking company which operates in the eastern part of the United States. I am here to address the need which I believe exists to seek a technical amendment to the recently enacted tax relief provisions allowing writeoffs of the tax basis of operating authorities over a period of 60 months.

By way of background, the Motor Carrier Act of 1980 vastly reduced the value of these operating certificates. These are the certificates that formerly enabled one to haul freight over certain points in the United States. As a result of the Motor Carrier Act, unquestionably these certificates were vastly reduced in value, and as a consequence the solution to the problem that Congress established was to permit the writeoffs of these authorities or the tax basis of these authorities over a period of 60 months.

How this worked is in effect, in the case of an outright purchase of operating authority there was no problem encountered whatsoever and the taxpayer would take the tax basis of his authorities and he would write off over 60 months the authorities, which is basically 20 percent a year for 5 years.

In the case of a stock acquisition of a company owning authorities, a special tax basis, rule was placed in the Internal Revenue Code, and this rule is somewhat complex and I will try very briefly to describe it to you. The way it worked was an individual—or rather, a corporation, and this is critical—a corporation that had acquired another corporation that owned ICC operating authority was allowed a very special rule, which was to treat the purchase of the corporation who owned the authority as if it had bought the operating authority itself.

So for example, if you bought a company with tangible book value, the excess over tangible book value represented what you paid for the operating authority. If you had a corporate taxpayer, it was then allowed to take this excess over book value and allocate this to the operating authorities, the ICC authorities. Thereafter he was permitted to go ahead and write it off over a period of 60 months.

If you take the identical transaction, but instead of a corporation purchasing the stock of the company that owned operating authorities, if you replace the corporation with an individual, that individual under the tax basis rules was not allowed to treat that transaction in an identical manner. In other words, the individual was not allowed to take the excess of the net tangible assets that he paid for the company, allocate it to the operating rights, and write that off over a period of 60 months.

I am here today because basically it is well established that all carriers—or all taxpayers were intended to be given the relief of this writeoff over 60 months. The taxpayer, whether it was a corporation, an individual, a trust or a partnership—in the drafting of the relief provisions, the only remedy that was legislated into the law under section 266 was directed toward corporate purchasers of other corporations that owned this authority.

Very simply, what I am asking for here today is a relief provision which does no more than correct an oversight of what Congress carefully deliberated on and legislated into the 1981 Economic Recovery Tax Act. This would just be a provision to correct the oversight by expanding section 266(c)(2) to enable a corporation acquired by individuals to elect to increase its basis in operating authority certificates where an individual purchased control, that is 80 percent, of the corporation that owned the authorities.

This is the identical test that the code requires of corporations that may purchase from such taxpayers.

Thank you very much.

[The prepared statement follows:]

Statement of Robert F. Long

Mr. Chairman and members of the Committee, my name is Robert F. Long and I am President of Daily Industries, Inc. I appreciate very much the opportunity to be heard by the Committee today with respect to a proposed technical amendment to the recently enacted legislation allowing holders of a "motor carrier operating authority" to deduct over a 5-year period an amount equal to the adjusted basis of such authority as of July 1, 1980. The purpose of my appearance today is to present for your consideration a particularly inequitable, and I believe, unforeseen, consequence resulting under this new statute and to suggest that this unintended situation be ameliorated as part of any technical corrections bill that may be passed in connection with the Economic Recovery Tax Act of 1981 ("ERTA").

I. BACKGROUND

Under the Interstate Commerce Act passed by Congress in 1935, interstate motor carriers were required to provide transportation services for the "convenience and necessity" of the general public. In order to insure that motor carriers satisfied this Congressionally mandated standard, the Interstate Commerce Commission ("ICC") began in 1935 to grant a limited number of operating authority certificates to those interstate motor carriers that could demonstrate in an administrative ICC proceeding that their services would serve the public convenience and necessity. Moreover, under ICC administrative procedures motor carriers with existing operating authority certificates were entitled to intervene in these proceedings to demonstrate that the public convenience and necessity would not be furthered by the issuance of a certificate to a new applicant.

The fact that applicants for a new ICC operating authority certificate were required to prove that their services would serve the public convenience and necessity, coupled with the right of existing certificate holders to oppose the applications before the ICC, gave the holders of these certificates a significant competitive advantage in the marketplace. As a consequence, these operating authority certificates became quite valuable, and in many cases represented a substantial part of a motor carrier's total assets.

On July 1, 1980, however, Congress enacted the Motor Carrier Act of 1980 which provided that the issuance by the ICC of new operating authority certificates need no longer be conditioned on the applicant's ability to demonstrate that his entry into the transportation market would serve the public convenience and necessity. Moreover, existing certificate holders desiring to intervene in ICC application proceedings bore the burden of proving that the proposed service was inconsistent with the public convenience and necessity. Therefore, although an ICC operating authority certificate was still required to gain entry into the interstate motor carrier business after July 1, 1980, the increased ease with which new carriers could gain entry into the market substantially diminished the value of existing certificates.

Notwithstanding the substantial depreciation in value of these operating authority certificates, under long-standing and well-established principles of Federal income taxation a motor carrier who held such a devalued certificate could not claim a tax loss for the amount of the devaluation because a loss deduction under section 165 of the Code is not permitted for a mere decline in the value of property. In many instances, this depreciation in the value of operating authority certificates, coupled with the inability of motor carriers to claim a corresponding tax loss deduction, resulted in serious economic burdens for motor carriers, many of whom held operating certificates which represented a substantial part of their equity and were often collateralized to raise capital.

II. SOLUTION UNDER ERTA

Congress attempted to resolve this inequitable situation by passing section 266 of ERTA, which generally provides that a taxpayer, who held an operating authority certificate on July 1, 1980, is entitled to deduct ratably over a 60-month period an amount equal to the taxpayer's adjusted basis in such authority as of July 1, 1980. Section 266(c)(2)(A) sets forth a special rule for computing the adjusted basis of an operating authority certificate in the case of certain stock acquisitions.

This special basis adjustment rule provides that in cases where a corporation acquired on or before July 1, 1980, stock in a second corporation which held an operating authority certificate at the time of the acquisition, the holder of the certificate (i.e., the second corporation) may elect to increase its adjusted basis in the certificate by the amount that would have been attributed to the certificate if the acquiring corporation had, immediately after the acquisition liquidated the holder under section 334(b)(2) of the Code. By the addition of this new basis provision Congress placed on an equal footing for tax purposes (i) certificate holders whose stock had been acquired by a corporation which, for one reason or another, had chosen not to liquidate the holder with (ii) those taxpayers (both corporate and non-corporate) who will obtain an increased basis in a certificate as a result of having purchased the certificate from the holder either (1) directly or (2) indirectly through a liquidation of the corporate certificate holder.

III. PROBLEM

The motor carrier operating authority deduction provided for in section 266 of ERTA is, by the very language of the statute, available to all "taxpayers," which term is defined in section 7701(a)(14) of the Code as any "person" subject to any internal revenue tax. The term "person" is defined in section 7701(a)(1) of the Code as "an individual, a trust, estate, partnership, association, company or corporation." Accordingly, it is clear under the statute that all classes of taxpayers who held motor carrier operating authority certificates on July 1, 1980, are eligible to claim the new motor carrier operating authority deduction.

The special basis adjustment provision of section 266(c)(2)(A) as presently drafted, however, is limited to situations in which the stock of a certificate holder was acquired by a corporation and does not appear to permit a similar basis adjustment where the holder's stock was acquired by a non-corporate taxpayer. There is no reason in logic or equity which justifies such a difference in tax treatment, and any "protection of the revenue" considerations are de minimus at most. If anything, as a matter of tax policy, the small business taxpayer—usually individuals or a partnership—should obtain a competitive advantage of the type conferred by section 266. In any event, such an advantage should not be restricted to corporate acquirers; rather, all classes of acquiring taxpayers, both corporate and non-corporate, should be treated in the same manner.

The discrimination between corporate acquirers and non-corporate acquirers can be demonstrated by the following simple illustration. Assume on January 1, 1976

Mr. A and Mr. B acquired all the outstanding stock of Truckco, a small trucking company, and paid an amount in excess of the tangible asset value of Truckco which amount represented the value of certain valuable certificates of Truckco. Under the existing statute Truckco may not elect to increase its adjusted basis in the certificates by the amount attributable to such certificates at the time of the acquisition because Mr. A and Mr. B acquired all the Truckco stock in their individual capacities. On the other hand, had Mr. A and Mr. B formed a new corporation, to act as the vehicle to acquire Truckco, then Truckco could, under section 266(c)(2)(A), elect the basis adjustment to reflect the amount paid for its certificates. It obviously would have been a simple matter to form a corporation to effect the acquisition of Truckco and Mr. A and Mr. B would undoubtedly have followed that course of action had they been aware that over 5 years later such a simple change in the form of the acquisition would produce drastically different tax ramifications. It is patently unfair and inequitable to penalize non-corporate taxpayers, such as Mr. A and Mr. B, who did not and could not appreciate the dire consequences of acquiring as non-corporate taxpayers a trucking company with valuable certificates.

IV. SOLUTION TO THE PROBLEM

The inequity created by section 266(c)(2)(A), as presently drafted, could be easily remedied by the addition of a new subparagraph which would permit certificate holders whose stock had been acquired prior to July 1, 1980, by non-corporate taxpayers the same basis adjustment benefit that is presently accorded to holders whose stock happened to have been acquired by a corporation prior to that date.

Therefore, I believe and strongly recommend that any technical corrections bill that is enacted with respect to ERTA should provide for the addition to section 266(c)(2) that would enable a corporation that has been acquired by non-corporation taxpayers to elect to increase its adjusted basis in the certificates it holds to reflect the amount paid for such certificates. The amendment should, however, be limited to situations where the non-corporate taxpayers purchased at least 80 percent of the stock of the corporate certificate holder. This would place similarly situated corporate and non-corporate acquiring taxpayers on a parity and eliminate the economic disadvantage imposed by existing law upon trucking companies purchased by non-corporate taxpayers which compete on a daily basis for a share of the available business against large, well-financed trucking companies that do qualify for the intended tax benefit.

Mr. ANTHONY. Thank you very much, Mr. Long.

Mr. Meyer, do you have any additional comments you would like to make?

Mr. MEYER. Just one, Mr. Chairman. It seems, as Mr. Long indicated, that this was clearly an oversight from the standpoint of allowing a corporation to increase its adjusted basis. The situation, as Mr. Long has indicated, is one where individuals who purchase trucking companies without using a corporation to acquire the trucking company, because it was not necessary to use an intervening corporation, now find after the fact that had they set up a corporation the only purpose of which would be to acquire the trucking company they would be entitled to the writeoff.

Through that simple expediency, therefore, they would have come clearly within the provision. On the other hand, by not having done so, but still acquiring the requisite 80 percent, they are denied this deduction.

It seems to us that this was clearly an oversight at the time that the law was drafted.

Mr. ANTHONY. Do you have any study that has been conducted or prepared that would indicate how many people, how many entities, are affected by this? Are you affected by it yourself, Mr. Long?

Mr. LONG. Yes, Mr. Anthony.

Mr. ANTHONY. Do you know of others?

Mr. LONG. In discussing the problem with our trade association, I am made aware of only one other member in the entire American

Trucking Association who is in this condition. Having personally spoken to that other member, it doesn't seem that their problem has nearly the dimensions to it that ours does in terms of the magnitude of the tax loss.

Mr. **Anthony**. Do you feel that if the committee failed to respond and correct what you consider to be a technical oversight, it would put your particular business at a competitive disadvantage compared to others who have used the corporate structure?

Mr. **Long**. Unquestionably. Every day we compete within our industry with all other taxpayers who have been granted this relief, without question, I can answer that truthfully.

Mr. **Anthony**. So really, all you are asking this committee to do, then, is to put you on an equal level with your competitors?

Mr. **Long**. That is all, sir.

Mr. **Anthony**. To treat you fairly under the tax code.

Mr. **Long**. That is correct.

Mr. **Anthony**. It makes sense at least to one member.

Do any other members of the committee have any comments or questions?

Mr. **Martin**. No, Mr. Chairman.

Mr. **Anthony**. We thank both of you for your testimony today.

Mr. **Long**. Thank you.

Mr. **Anthony**. The committee will adjourn subject to the call of the Chair.

[Whereupon, at 3:55 p.m., the hearing was adjourned.]

[The following were submitted for the record:]

AMERICAN ASSOCIATION OF EQUIPMENT LESSORS,
Arlington, Va., April 26, 1982.

Re H.R. 6056, a bill to make technical corrections to the Economic Recovery Tax Act of 1981, etc.

Hon. DAN ROSTENKOWSKI,
Chairman, House Ways and Means Committee,
Washington, D.C.

DEAR CONGRESSMAN ROSTENKOWSKI: We are writing on behalf of the American Association of Equipment Lessors to oppose the enactment of section 102(h)(2) of H.R. 6056, which would amend section 44F(b)(2)(A)(iii) of the Internal Revenue Code of 1954, as added by the Economic Recovery Tax Act of 1981 ("the Act"). H.R. 6056 would provide that, for purposes of the credit for increasing research activities, "in house research expenses" do not include lease payments paid or incurred after March 31, 1982, other than payments for the use of computer time by a person who is not the principal user of the computer.

In our view, present section 44F(b)(2)(A)(iii) reflects a careful and deliberate decision made by the Congress when it approved the Act. That section clearly provides that "in house research expenses" include "any amount paid or incurred to another person for the right to use personal property in the conduct of qualified research," and does not contain or imply the limitations now being proposed by H.R. 6056. In addition, the Conference Report on the Act indicates that the Congress considered, but rejected, a more limited definition of such research expenses. See H. Report No. 97-215, 97th cong., 1st Sess., p. 223 (August 1, 1981). The Conference Report notes that the bill as passed by the House provided that qualifying research expenditures would include "certain lease or other charges for research use of computers, laboratory equipment, etc.," but that, on the other hand, the bill as approved by the Senate provided that such expenses would include only "certain lease or other charges for research use of computers (but not for the use of other equipment)". The Conference agreement and the final version of the Act approved by the Congress followed the broader House bill. Moreover, the Treasury Department's temporary regulations relating to the special rule for leases indicate (§ 5c.168(f)(8)-1(b)) that amounts paid or incurred to another person for the right to use personal property in the conduct of qualified research are eligible for the research expenditure credit if paid or incurred under leases which are leases without regard to the special rule for leases of § 168(f)(8) of the Act. There is no suggestion of any limitation to computer time use.

We believe that the purpose of present section 44F(b)(2)(A)(iii) is sound and in the public interest. The inclusion of lease payments as eligible expenses for the credit provided by section 44F will assist high technology companies to acquire the use of equipment needed for the conduct of their research and development activities. We further believe that the language and legislative history of that section are clear, and that the amendment proposed by section 102(h)(2) of H.R. 6056 is neither necessary nor desirable.

Sincerely,

MICHAEL FLEMING, *Executive Director.*

AMERICAN GAS ASSOCIATION,
Arlington, Va., April 30, 1982.

Mr. JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. SALMON: The American Gas Association (A.G.A.) is a national trade association comprised of nearly 300 natural gas transmission and distribution companies. A.G.A. member companies provide natural gas to approximately 160,000,000 consumers in all 50 states and account for about 85 percent of all gas utility sales in our nation each year.

Many A.G.A. member companies are involved in the exploration and development of oil and natural gas. For the reason, A.G.A. offers the following attached statement on the definitions of "crude oil" and "independent producer"for purposes of the windfall profit tax.

A.G.A. respectfully requests that this letter and the attached written statement be incorporated in the written record on H.R. 6056, The Technical Corrections Act of 1982.

Respectfully submitted.

MICHAEL BALY III,
Vice President, Government Relations.

STATEMENT OF AMERICAN GAS ASSOCIATION ON H.R. 6056

THE DEFINITION OF CRUDE OIL FOR PURPOSES OF THE WINDFALL PROFIT TAX

The A.G.A. fully recognizes that it is often necessary after the passage of complex tax legislation for the Congress to enact subsequent technical corrections in order to cure drafting errors and clerical defects. Such correcting legislation is helpful to both taxpayers and the government by assuring that the intended purpose of the original legislation is carried out.

It was in this spirit that H.R. 6056 was introduced by Chairman Rostenkowski and Rep. Conable and supported by Assistant Secretary of the Treasury Chapoton. Con. Rec, H. 1390, 1394 (April 1, 1982); Treasury News Release (April 27, 1982). As noted by them, H.R. 6056 is not intended to provide a vehicle for reconsidering substantive issues.

In amending the definition of "crude oil" for purposes of the windfall profit tax, however, section 201(h)(2) of the bill seriously violates the spirit of the proposed legislation. Section 201(h)(2) introduces a highly controversial amendment that provides a new and different substantive rule from that agreed to at the time of enactment of the windfall profit tax. The amendment would define "crude oil" to include "condensates recoverable from natural gas (whether or not recovered before the natural gas is removed from the premises.)". This is a significant substantive change from the current windfall profit tax definition of crude oil.

Section 4996(b)(1) of the Code presently defines crude oil as having the same meaning as given to the term by the June 1979 energy regulations. Those regulations define crude oil as follows: "Crude oil" means a mixture of hydrocarbons that existed in liquid phase in underground reservoirs and remains liquid at atmospheric pressure after passing through surface separating facilities. "Crude oil" includes condensate recovered in associated or non-associated production by mechanical separators, whether located on the lease, at central field facilities, or at the inlet side of a gas processing plant. 10 C.F.R. § 212.31 (Emphasis added.)

As orginally enacted, therefore, the windfall profit tax definition of crude oil clearly focused on condensate that had been "recovered". A change in that definition to include condensate that is theoretically "recoverable," although not actually recovered, is much more than a technical or clerical amendment of the original statute. It constitutes a highly important substantive change in the original legislation and should not be included in what is intended to be a noncontroversial technical corrections act.

The proposed modification of the definition of crude windfall profit tax would extend the reach of the tax beyond its originally intended scope. The windfall profit tax is inextricably linked to the decontrol of domestic crude oil prices. The underlying theory of the tax was to capture for the government a portion of the so-called "Windfall profit" derived by producers from the price increase they would receive for their production as domestic crude oil was released from price control and allowed to rise to a free market level. Therefore, the windfall profit tax was imposed on the same crude oil that had been subject to price control and which would benefit from the decontrol of oil prices. Thus, the definition of "crude oil" for windfall profit tax purposes is properly the same as the definition of "crude oil" for price control purposes in the energy regulations

The price control definition of crude oil limits the inclusion of condensate to condensate actually at certain facilities. It does contain any reference to condensates that are merely "recoverable" from natural gas. Natural gas sold by a producer would be subject to the price control system imposed by the Natural Gas Policy Act of 1978 (NGPA), but would not be subject to the crude oil price controls. Thus, regardless of whether a gas stream contains any recoverable condensate, the sale of gas would be treated as a gas sale subject to NGPA, rather than as a crude oil sale subject to crude oil price controls. As a result, no portion of the purchase price received by that producer should properly represent a "Windfall profit" caused by the decontrol of crude oil prices.

Since there is no Treasury Department explanation accompanying the proposed amendment to the definition of crude oil, the A.G.A. is not certain of its intended purpose. Presumably, the amendment is aimed at some perceived abuse whereby a producer might deliberately avoid recovering condensate from a gas stream and thereby avoid the windfall profit tax. If such a potential abuse does exist, and this is doubtful, there is surely a more equitable manner of preventing it than to subject the entire industry to an unwarranted expansion of the tax.

As a practical matter, in the usual case, the producer is interested in obtaining from the gas stream as much condensate as possible due to its high selling price in relation to the price of gas, much of which gas is still controlled under NGPA. Therefore, the producer generally will separate the condensate himself, or have it separated for his account. Although there may be times when a producer will elect not to install separating facilities in the field, this is not because he seeks to avoid the windfall profit tax. Rather, it is because the amount of condensate to be recovered from his natural gas does not economically justify the expense. In these relatively few cases, the producer may sell a "wet" gas stream to a natural gas transmission company even though the company would prefer to receive a dry gas stream. When this occurs, the producer is paid the lawful selling price for his production as gas and there is no separate compensation received by the producer for the value of condensate that would have been recovered from the gas. Any condensate which may later form in the transmission company's pipeline is the sole property of the pipeline company; the producer has no interest in it whatsoever. Since the producer has received a price only for natural gas and not for crude oil that has benefitted from decontrol, he has received no "windfall" from the transaction. Accordingly, to treat any portion of his receipts as being from "crude oil" subject to the windfall profit tax would constitute an unjustifiable extension of that tax beyond its original scope and purpose.

Furthermore, such an extension of the tax in a technical corrections bill which would have retroactive effect is extremely inequitable. Given the explicit definition contained in section 4996 of the Code and the energy regulations, no producer or purchaser would have suspected a windfall profit tax liability to be due on natural gas sales. The proposed "technical correction" could retroactively create such a liability and the accompanying potential liability of the purchaser for a failure to withhold tax. Interest charges would also be due on any liability so created.

Finally, the recoverable condensate concept would entail substantial administrative difficulties for what would likely be a very small revenue increase. Presumably, the determination of the recoverable condensate content of natural gas would require extensive well testing and recordkeeping. In addition, numerous natural gas producers and purchasers would be subjected to the onerous windfall profit tax certification, reporting, and filing system in order to tax what are often small fractional interests in minor amounts of recoverable condensate.

For all of these reasons, the A.G.A. submits that proposed section 201(h)(2) be deleted from H.R. 6056.

THE DEFINITION OF INDEPENDENT PRODUCER FOR PURPOSES OF THE WINDFALL PROFIT TAX

If Congress does decide that, in the context of the technical corrections bill, substantive modifications of the windfall profit tax will be accepted, A.G.A. recommends the following discussion and change be adopted with respect to the definition of "independent producer".

Although the crude oil windfall profit tax was enacted essentially as quid pro quo for the decontrol of crude oil pricing regulations, Congress did provide smaller independent oil producers lesser tax rates to foster competition between these companies and the major integrated oil companies. However, many A.G.A. member companies which produce crude oil, either in association with natural gas production or independently, are unable to take advantage of the favorable independent producer rates under the Crude Oil Windfall Profit Tax of 1980 (Pub. L. No. 96-223)[1] due to their corporate association with natural gas distribution and retail activities. As a result, these companies are required to pay the same windfall profit tax rates paid by the major integrated oil companies even though the A.G.A. member companies' oil production levels are generally well within the range of smaller independent oil producers.

The decontrol of oil pricing regulations and the imposition of the windfall profit tax bears no logical relation to the production, pricing or sale of natural gas. Nevertheless, specifically because the windfall profit tax uses the definition of "independent producer" from the context of the percentage depletion allowance,[2] oil and gas exploration companies are denied the favorable independent producer rates simply because these companies are in the same corporate family as a natural gas distribution operation with more than $5 million in annual retail sales of natural gas.

A.G.A. believes that it is unwarranted and illogical to deny eligibility for the independent producer rates on crude oil simply because of an oil producer's affiliation with natural gas retail activity. Indeed, it is inconsistent with the intent underlying the creation of the favorable independent producer rates particularly since the oil production from these companies is frequently incidental to the production of natural gas, or generally well within the levels of oil production attributable to smaller independent producers.

A.G.A., therefore, urges that the definition of "independent producer" for purposes of the crude oil windfall profit tax be modified to disregard any consideration of whether an oil producer has any corporate affiliation with a natural gas retailer. Congress James Jones (D-OK) has introduced legislation, H.R. 1329, which would accomplish this result. To so modify the definition would achieve the equitable result of granting small oil producers, who are in the same corporate family as a natural gas distribution company, the favorable independent producer rates under the windfall profit tax.

A.G.A. is grateful for this opportunity to present its views on H.R. 6056, The Technical Corrections Act of 1982.

* * * * * * *

April 30, 1982.

STATEMENT OF THE AMERICAN PAPER INSTITUTE

The American Paper Institute (API) welcomes this opportunity to comment on H.R. 6065, "Technical Corrections Act of 1982."

In November 1981 we submitted recommendations for technical corrections in the Economic Recovery Tax Act of 1981 to the Treasury Department. These included proposed changes in both the statutory language and suggestions for incorporation in the implementing regulations.

---

[1] Section 4987(b)(2) of the Internal Revenue Code of 1954 provides that windfall profit tax rates for independent producers shall be 50 percent for Tier 1 oil (compared to 70 percent for integrated oil companies) and 30 percent for Tier 2 oil (compared to 60 percent for integrated oil companies).

[2] Section 613A of the Internal Revenue Code of 1954.

We applaud the efforts of this Committee in correcting many of the technical errors in the Economic Recovery Tax Act of 1981. However, some technical problems remain, and we would like to bring two of these items to the Committee's attention.

DISPOSITION OF RECOVERY PROPERTY—MASS ASSET ACCOUNTS

Sec. 201(a) of ERTA.
IRC Sec. 168(d)(2)(A).

As a capital intensive industry, we need particular guidance with respect to mass asset accounting. We recommend that the statute provide that the election to include in income all proceeds from dispositions within a taxable year be an annual election with respect to each class of recovery property. The statute currently provides no guidance with respect to this problem area.

DEPRECIATION OF REAL PROPERTY

Sec. 201(a) of ERTA.
IRC Sec. 168(b)(2).

Under IRC Sec. 168(b)(2), taxpayers would be required to maintain as many as twelve separate accounts for each year's additions of industrial real property.

The statute should provide that the taxpayer may continue to elect a half-year convention with respect to 15-year industrial real property in order to greatly minimize the administrative burden of accounting for numerous additions throughout the year. This option would be consistent with the half-year convention required under ACRS for other recovery property.

We thank you for this opportunity to recommend specific changes in the statute, which will provide necessary guidance and rational treatment for taxpayers.

STATEMENT ON BEHALF OF THE AMERICAN PETROLEUM INSTITUTE

The American Petroleum Institute through its tax committees has reviewed the "Technical Corrections Act of 1982," H.R. 6056, and would like to commend the Committee and the staff on efforts to identify and deal with the technical problems which have surfaced in implementing the Crude Oil Windfall Profit Tax (WPT) since its enactment. Recognizing that more than two years has elapsed since enactment, and that extensive efforts have been and are continuing to be made by Treasury and the Internal Revenue Service to resolve many of the technical problems thought to exist with respect to the WPT, we would recommend that action on some of the proposals be deferred pending completion of administrative review and resolution. With this in mind we would offer the following comments and suggestions.

DEFINITION OF CRUDE OIL

Section 201(h)(2) of Title II of the Technical Corrections Act of 1982 amends the Windfall Profit Tax (WPT) definitions of crude oil by adding the following sentence to the end of that definition: "Such term includes condensates recoverable from natural gas (whether or not recovered before the natural gas is removed from the premises)."

While this amendment may be intended to "remove any doubt that condensate from oil and gas wells is taxable whether recovered before or after removal from the premises on which it was produced," it may create new uncertainties as to the appropriate method of determining taxable volumes of all condensate. Moreoever, we question whether the proposal as written addresses the technical problem under Section 4996(b)(3) relating to the definition of "domestic" and its effect on the definition of "taxable crude oil."

We are concerned that the use of the term "recoverable" without reference to volumes actually recovered may be construed as substituting a theoretical calculation for specific measurement of actual recoveries of condensate in determining the taxable volume in all cases. Such an interpretation would constitute a material change to the law and would create enormous measurement problems because the arbitrary conditions of temperature and pressure upon which a theoretical calculation is based seldom coincide with normal operating conditions.

The DOE definition of crude oil included condensate within its ambit but did not require "recoverable" calculations to determine the controlled substance: "It (crude oil) includes condensate recovered in associated and nonassociated production by mechanical separators whether located on the lease, at central field facilities, or at the inlet side of a gas processing plant." 10 C.F.R. 212.31

This definition would seem to deal adequately with the condensate issue without adding confusion as to whether the actual recoveries that were controlled by the DOE are the volumes that should be used in computing WPT liability or some theoretically "recoverable" volumes. It is our opinion that only actual condensate volumes recovered by or on behalf of the producer through mechanical separation whether located at the lease or at central field facilities or through initial mechanical separation at the inlet side of a gas processing plant should be the volumes considered crude oil for purposes of the WPT. Actual recoveries subsequent to such mechanical separation should not be considered crude oil.

This approach we believe is fair, workable, acceptable to industry and not subject to abuse. In the majority of situations natural gas streams must be and are mechanically separated prior to gas processing or transmission. The liquids that are recovered through initial mechanical separation are termed condensate and have traditionally been priced, classified and accounted for by industry as crude oil. Under lease and gas processing agreements, condensate recovered through initial mechanical separation is usually allocated in full to the producers with the economic interest. However, in some situations producers may be selling "wet" gas in the field subject to NGPA price controls. Taxing producers receiving no benefit from crude oil decontrol is inconsistent with the basic thrust of the Crude Oil Windfall Profit Tax. If purchasers/producers attempt to avoid arms-length contractual arrangements, royalty and other interest owners would most assuredly pursue all legal remedies to protect these valuable contract rights. In many states, gas purchasers/porocessors are strictly regulated in their dealings with producers to insure that such purchasers/processors do not improperly divert to themselves the recovered condensate. For example, the Texas Railroad Commission Rules require that liquids recovered from casinghead gas by gas plant processors over and above 3/4 barrel per well per month must be allocated to producers, Texas Railroad Commission Rule 56(a). We believe that these checks and balances insure that proper separation occurs and that the economic interest owner will receive the benefit for the condensate actually recovered. Those volumes, as stated earlier, should be the taxable volumes. To institute some form of arbitrary formula and/or metering not related to the actual volumes recovered and sold would be burdensome, costly and obviously controversial.

TREATMENT OF NET PROFITS INTERESTS

The changes proposed with respect to net profits interests in Section 201(h) raise significant questions that cannot be adequately addressed in the context of a technical amendments act.

The definition of Net Profits Agreement in proposed Section 4996(h)(1) is stated in such a manner that it may also be applicable to carried interests as well as certain types of farm out agreements. If qualified costs as defined in proposed Section 4996(h)(3) do not encompass all costs permitted to be recovered under the contract, including windfall profit tax, then dual calculations of payout status may be required, thereby adding additional complexities. The effects of gas revenue in a net profits agreement have not been addressed nor have the problems of what particular oil by tax tier and removal price is to be treated as cost recovery oil. Qualified costs transferred to a net profits owner under proposed Section 4988(b)(6)(B) may not be deductible by the net profits owner under Section 4988(b)(3)(B).

Furthermore there has been inadequate time to address the economic effects of the proposed changes on the infinite variety of net profits interests that exist throughout the petroleum industry. Net profits owners in different properties producing the same revenue and "windfall profit" would be treated quite differently, depending on relative operating costs. If one of the properties were twice as expensive to operate as the other, it would appear that the net profits owner in that property would receive only half as much taxable crude oil as the net profits owner in the less costly property. Yet the proposal seems to treat both as receiving exactly the same volume of crude oil. Situations can arise where a net profits owner entitled to no payment under the contract could be treated as being liable for windfall profit tax even after net income limitation. A working interest owner, subject to net income limitation, could find his windfall profit tax increased merely because he is treated as in receipt of fewer barrels under the proposal than under present law. In this situation the tax recovered from an exempt net profits owner under the contract would also increase.

There may be additional problems with the proposed on the royalty exemption for windfall profit tax purposes. In any event, all of these considerations lead us to the conclusion that action on this proposal should be deferred.

WITHHOLDING RULES

Amendment of Section 4995(a)(3) (A) and (C) seeks to alleviate certain withholding problems under the present law.

API supports the removal of the "withholding adjustment in excess of windfall profit" rule. Such action will eliminate the complexity arising from administering such rule and cash flow detriments which result from such rule for withholders of windfall profit tax.

API also supports having a longer period in which to make withholding adjustments than is currently provided in Temporary Treasury Regulation Section 150.4995-1(c)(1)(ii); i.e., not later than the time the annual statement (Form 6248) is furnished to the payee, which is March 31 of the year following the year the oil is removed from the premises. The proposed amendment to Section 4995(a)(3)(A) would allow the Secretary of Treasury to provide regulations designating the appropriate period of time within which withholding adjustments can be made. This approach should allow regulations to be adopted which would permit withholding adjustments for a reasonable period of time but not create problems with the statute of limitations for filing amended returns, filing claims for refund, etc. We would hope that no further limitation to such approach is intended by the language in the summary of H.R. 6056 which states: "Similarly, the reports would indicate agreement with the current cut off date for voluntary withholding adjustments."

PROBLEM AREAS NOT COVERED IN H.R. 6056

The following problem areas appear worthy of consideration for inclusion in the Technical Corrections Act of 1982.

CERTIFICATION OF HEAVY OIL

The definition of "heavy oil" in Section 4991(e)(3) should be amended to allow certification of current production as heavy oil on the basis of expectations concerning the gravity of the oil based on prior experience.

Section 4991(e)(3) defines heavy oil as all oil from a property if during (a) the last month of production before July 1979 or (b) the taxable period, oil produced from the property had an average gravity of 16 degrees or less. With respect to oil that qualifies as heavy under (b), the tax is withheld at the tier 1 or tier 2 rate with subsequent adjustments. An amendment is needed, for withholding purposes only, which would allow taxpayers to focus on gravity during the preceding quarter or, at least, to allow certification for deposits on the basis of reasonable expectations. This would prevent the administrative problems of having to withhold on one basis but adjusting such withholdings after the end of each taxable period based on the actual gravity of the crude oil.

FRONT-END TERTIARY OIL

The rules relating to front-end tertiary oil contained in Section 4994(c)(2)(C) should be clarified by amendment to provide that the term "tertiary incentive revenue" used in determining refunds for tertiary projects should be limited to that portion of such revenue which relates to the recovery of "allowed expenses." As currently worded, the term could be construed to include total tertiary incentive revenue under the energy regulations. Inasmuch as prepaid expenses are not taken into account for WPT purposes, such a construction would frustrate the intent of Congress which was to provide relief to both independent and integrated producers under the DOE front-end tertiary oil program.

POWERHOUSE OIL

A definition for "powerhouse oil" should be added to Section 4996(b) to clarify the windfall profit tax treatment for removal of oil to other tracts for processing, treating or temporary storage, from where such oil is returned to the lease for re-injection or to power production equipment. Oil used for re-injection or to power production processes or equipment is not benefitted by decontrol of crude oil prices unless sold for such purposes. Where there is no sale but only removal for processing, treating, or temporary storage before use, the oil should be exempt.

The Internal Revenue Service has unduly restricted this exemption by requiring not only that the two tracts were produced and processed, treated or stored be contiguous but also that 100 percent of the operating mineral interest in both tracts be held by the same persons. Furthermore, the oil must not have been transported from the tract from which it was produced to a tract with dissimilar ownership.

Often central facilities are used in a field for dehydration and other treatment of produced crude oil. The oil as produced is not suitable for use in the production process because of water and other impurities. If the central facilities are located on other than the tract or parcel of land on which the production takes place or the operating interests are different, then transporting the oil to these central facilities may constitute removal from the premises under Temporary Treasury Regulation Section 150.4996(d)(2). The results are a loss of the powerhouse oil exemption. We believe a technical amendment is needed to avoid this unintended loss of exemption for powerhouse fuel not sold for such purpose.

American Telephone & Telegraph Co.,
New York, N.Y., April 29, 1982.

Hon. Daniel Rostenkowski,
The House of Representatives,
Washington, D.C.

Dear Representative Rostenkowski: This statement is made on behalf of the American Telephone and Telegraph Company and associated Bell System Companies, which are listed in Exhibit A, with respect to H.R. 6056, the Technical Corrections Act of 1982.

The Economic Recovery Tax Act of 1981 changed for taxable years beginning after 12/31/82, the basis for computing the credit for contributions to Employee Stock Ownership Plans (ESOPs) from the amount of the taxpayer's qualified investment to the compensation paid to the taxpayer's employees. The normalization requirement applicable to regulated public utilities which had applied to the investment based ESOP's was carried over to the new compensation based ESOPs.

Section 103(f)(1) of H.R. 6056 is designed to correct certain ambiguities in the normalization requirements for compensation based ESOPs. We believe, however, that this corrective provision should be clarified in two respects to achieve its intended purpose.

First, the section should clearly state that these normalization rules apply to the same companies that are subject to the normalization requirements under the investment based ESOPs. Accordingly, we propose the addition of a reference to the definition contained in Code Section 46(c)(3)(B).

Second, we recognize the need to apply the normalization requirements only to regulated public utility activities in the case of a firm which has both public utility and non-public utility parts of its business. We are concerned that the reference in Section 103(f)(1) to the term "substantial" could give rise to controversies between taxpayers and the Internal Revenue Service, impose a heavy administrative burden on the IRS, and create uncertainly in the administration of the tax laws. Consequently, we have proposed language which we believe more directly accomplishes the intended objective.

The proposed modification to Section 103(f)(1) of H.R. 6056 to accomplish both of these clarifications is attached as Exhibit B.

Very truly yours,

R. N. Flint,
Vice President and Comptroller.

Attachments.

EXHIBIT A.—BELL SYSTEM CO.

American Telephone and Telegraph Company.
The Bell Telephone Company of Pennsylvania.
The Diamond State Telephone Company.
Bell Telephone Laboratories, Incorporated.
The Chesapeake and Potomac Telephone Company.
The Chesapeake and Potomac Telephone Company of Maryland.
The Chesapeake and Potomac Telephone Company of Virginia.
The Chesapeake and Potomac Telephone Company of West Virginia.
Cincinnati Bell, Incorporated.
Illinois Bell Telephone Company.
Indiana Bell Telephone Company, Incorporated.
Michigan Bell Telephone Company.
The Mountain States Telephone and Telegraph Company.
New England Telephone and Telegraph Company.
New Jersey Bell Telephone Company.

New York Telephone Company.
Northwestern Bell Telephone Company.
The Ohio Bell Telephone Company.
Pacific Northwest Bell Telephone Company.
The Pacific Telephone and Telegraph Company and Bell Telephone Company of Nevada.
South Central Bell Telephone Company.
Southern Bell Telephone and Telegraph Company.
The Southern New England Telegraph Company.
Southwestern Bell Telephone Company.
Western Electric Company, Incorporated.
Wisconsin Telephone Company.

EXHIBIT B

Section 103(f)(1) is amended by striking out paragraph 4(B) and inserting in lieu thereof:

"Paragraph (3) shall apply only to the credit earned with respect to compensation paid in a trade or business specified in section 46(c)(3)(B)."

Statement of Joe E. Day, Vice President (Tax), Aminoil USA, Inc.

Mr. Chairman, members of the commitee, Aminoil USA, Inc., a wholly-owned subsidiary of R. J. Reynolds Industries, Inc., is pleased to have the opportunity to present its comments on the energy provisions of H.R. 6056, the Technical Corrections Act of 1982, as introduced by Chairman Rostenkowski on April 1, 1982. From the outset, Aminoil would like to commend the Chairman and the entire Committee on Ways and Means for the timely manner in which these hearings have been called, and moreover, for the recognition by the Committee of the need for specific technical corrections to the Economic Recovery Tax Act of 1981 ("ERTA"), the Crude Oil Windfall Profit Tax Act of 1980 ("COWPTA"), and the Installment Sales Revision Act of 1980 ("ISRA").

As is true with any legislation, and particularly in the case of taxation measures, it generally takes a minimum of one year to fully appreciate the impact of such measures. While the timetable in this regard has been accelerated with respect to ERTA, the fact remains that it is virtually impossible for this Committee or the Congress to write a major tax bill that addresses every conceivable contingency that a given piece of legislation is intended to address. As a result, amendments or corrections must be considered and enacted, where appropriate, to more fully reflect the original intent of Congress. This is the stated purpose of H.R. 6056, and Aminoil applauds the Committee's efforts in this regard.

INDEPENDENT PRODUCER STRIPPER WELL OIL EXEMPTION

One item contained in H.R. 6056 is of particular importance to independent producers of crude oil. This provision, Sec. 106(b) of H.R. 6056, clarifies the transfer rules relative to the independent producer stripper well oil exemption as provided in Sec. 603 of ERTA.

Under ERTA, independent producer stripper well oil was made exempt from the windfall profit tax, beginning January 1, 1983. It was however provided in Sec. 603(b) of ERTA that "exempt stripper well oil does not include production attributable to an interest in any property which at any time after July 22, 1981, was owned by a person other than an independent producer (within the meaning of Sec. 4992(b)(1)". The inclusion of this limitation provision was clearly intended to prevent stripper well production from gaining exempt status through the transfer of properties from integrated companies to independent producers. The provision as enacted however seemed to forever deny any benefit from the stripper well exemption to independent producers such as Aminoil that for any single quarter subsequent to July 22, 1981 failed to meet all the qualifications for independent producer status. Consequently, though the producer qualified for independent producer status, if it did not qualify for all previous periods, its stripper well production would not be exempt since such production was owned by a person other than an independent producer after July 22, 1981. This is true even though such properties have not been transferred in any manner whatsoever.

To remedy this situation, Sec. 106(b) of H.R. 6056 proposes to clarify that the transfer limitation relative to the stripper well oil exemption disqualifies only a property which has actually been transferred. This technical correction to ERTA both clarifies the applicability of the stripper well oil exemption to certain producers and at the same time preserves the original intent of Congress to prevent exempt stripper well status from being gained through the transfer of properties from integrated companies to independent producers. In arriving at this proposed language, Aminoil wishes to thank the Committee and its staff for its interest and willingness to make this technical correction to ERTA. Accordingly, Aminoil urges the Committee's favorable considerable of Sec. 106(b) during its mark-up of H.R. 6056.

POWERHOUSE OIL EXEMPTION

Another item of importance to Aminoil and other producers, which is presently not included in H.R. 6056, concerns the powerhouse oil exemption from the windfall profits tax. Therefore, Aminoil would like to take this opportunity to briefly describe the unique problem that confronts Aminoil in interpreting the applicability of the powerhouse oil exemption to its Huntington Beach, California offshore operations.

As the Committee is well aware, the windfall profit tax attaches at either of two events—the first sale of crude oil if the sale is made on the premises, or at the time crude oil is removed from the premises. As provided in the conference report to COWPTA (Joint Explanatory Statement of the Committee of Conference to H.R. 3919, Rept. No. 96-817, page 105), and the regulations promulgated by the Department of Treasury (§ 150.4996-1(d)(2)), oil used for reinjection or to power the production process or production equipment is exempt from COWPTA if it is not removed from the premises. One of the major uses of powerhouse oil is to fuel large scale steam drive or tertiary recovery projects.

Aminoil's Huntington Beach Field has produced crude oil from offshore leases since 1939. Due to restrictions imposed by California law, the operations conducted at Huntington Beach are extremely unusual. Under State law in 1939, a lessee of offshore oil deposits was permitted to produce crude oil only from wells drilled directionally from inland drill sites to the submerged oil deposits or drilled on man-made islands (See California Public Resources Code, Sec. 6973 (West)). Consequently, when Aminoil's predecessor in interest first obtained the Huntington Beach leases, it was necessary to acquire an upland drill site from which the wells could be drilled into the offshore deposits. The necessary drilling area, a narrow strip of land (hereinafter the "Strip") which runs parallel to the beach and separated from the beach by U.S. Highway 101 (Pacific Coast Highway), was obtained through agreement with certain upland owners who granted the surface and subsurface rights necessary to construct, use and maintain all equipment necessary for drilling for production of crude oil from the offshore leases. This agreement granted only the right to drill into the offshore leases and conferred no right to production that might exist under the Strip.

In order to produce crude oil from the offshore leases in which Aminoil holds a mineral interest, directional drilling from the Strip is employed. This requires drilling under U.S. Highway 101, an adjacent railroad easement and beach, and ultimately into the offshore lease. The resulting crude oil is removed from the offshore mineral lease to the Strip on which it is produced. In addition to the production wells, the Strip houses crude oil processing, treating and storage facilities. There are no refining operations conducted on the Strip.

The crude oil produced from the Huntington Beach Field is relatively heavy with a gravity generally in the range of 20° API or below. As a result, Aminoil employs various enhanced oil recovery methods to facilitate the flow of this oil to the surface. These methods include injection of steam, chemicals, and water from the Strip. Combustible generators are used to inject or drive the various substances into the reservoir to enhance crude oil recovery. Aminoil fuels these generators in part with oil produced from the offshore leases.

Under the Department of Treasury regulations noted above, oil may be considered removed from the premises (and thus not eligible for the Powerhouse Oil exemption) if it is removed to a non-contiguous tract or parcel of land, or if it is removed to a contiguous parcel with a different operating mineral interest. Further, the COWPTA conference report indicates that oil may be considered removed from the premises if it crosses a public road.

Although Aminoil does not remove its powerhouse oil from the Strip on which it is produced, such oil may not qualify for the Powerhouse Oil exemption because:

(1) It is moved through directionally drilled wells to a non-contiguous property (the Strip) with a different operating mineral interest; and

(2) The directionally drilled wells cross beneath a public roadway.

Aminoil does not believe that the COWPTA conferees intended to effectively deny the Powerhouse Oil exemption to offshore production operations where by necessity the oil must be moved onshore before it is produced. In the case of Aminoil's Huntington Beach operations, the Powerhouse Oil is consumed and reinjected as steam on the same Strip from which the oil is produced through directional wells.

In an effort to resolve this matter administratively, Aminoil on April 2, 1982, formally filed a ruling request with the Internal Revenue Service ("IRS") requesting the IRS to rule that oil used on the Strip at Huntington Beach to fuel a steam generator is not removed from the premises for the purpose of the windfall profit tax powerhouse oil exemption. At the present time, there is no indication from the IRS as to when a ruling may be issued. In view of the administrative delay that could result from the Service's consideration of this ruling request, Aminoil respectfully urges this Committee to consider remedial language to COWPTA during its markup of H.R. 6056 to ensure that oil used for powerhouse purposes in the limited setting where such oil is produced offshore, but used for reinjection or to power the production process or production equipment from an onshore tract of land on which the oil is produced is accorded an exemption from COWPTA. Aminoil believes that such an amendment would indeed be technical in nature, and moreover, would more fully reflect the original intent of the conferees to COWPTA.

Similarly, Aminoil does not feel this issue should be prejudiced from consideration by this Committee simply because of the pendency of its ruling request before the IRS. The vast majority of the issues to be addressed by H.R. 6056 have not been ruled upon administratively, and as a result, the Powerhouse Oil technical correction should not be treated any differently. Consequently, Aminoil encourages the Committee to include a technical correction amendment in H.R. 6056 to clarify the applicability of the Powerhouse Oil exemption from COWPTA to the unique crude oil operations described more fully herein.

DEFINITION OF CRUDE OIL

Aminoil's final item for comment concerns the proposal in H.R. 6056 to add to the definition of crude oil in the COWPTA: "Such term includes condensates recoverable from natural gas (whether or not recovered before the natural gas is removed from the premises).

In the summary of H.R. 6056, the stated purpose of this amendment is to remove any doubt that condensate from oil or gas wells is taxable whether recovered before or after removal from the premises on which it is produced. The language included in H.R. 6056 on the other hand seems to go far beyond this stated intent and may be interpreted as meaning that all condensate which theoretically could have been recovered from a gas stream is included in the definition of crude oil. If this interpretation is intended, Aminoil believes this change is both unnecessary and unduly burdensome. Under COWPTA the term crude oil has the meaning given to the term by the June 1979 energy regulations, Sec. 496(b)(1). In the energy regulations it was defined as follows: "Crude oil" means a mixture of hydrocarbons that existed in liquid phase in underground reservoirs and remains liquid at atmospheric pressure after passing through surface separating facilities. "Crude oil" includes condensate recovered in associated or non-associated production by mechanical separators, whether located on the lease, at central field facilities, or at the inlet side of a gas processing plant. 10 CFR Sec. 212.31.

The energy regulations were concerned with the sale of the condensate. Condensate is not usually sold as such before its recovery from natural gas so the point at which the condensate was recovered became determinative of when the energy regulations attached since this was usually the point of first sale. The definition, of course, covers both condensate recovered before and after removal from the premises. Consistent with this meaning, Aminoil and others in industry have gone through much effort and expense to assure that the proper windfall profit tax is withheld from condensate. For condensate recovered on the premises, Aminoil was able to modify its system developed for withholding, depositing and reporting of crude oil windfall profit tax. But for condensate recovered after removal from the premises, a special system was required and was developed by Aminoil to comply with the COWPTA. The proposed change would require development of still another system to determine a theoretical volume and withholding for condensate that could have been recovered. The development of such a system could cost Aminoil in excess of one million dollars.

Aminoil understands the intent of this amendment is to prevent circumvention of the COWPTA by leaving condensate in a natural gas stream until after the stream enters a gas plant. While the proposed definition may cover that problem, it does so at the expense of companies such as ourselves who have diligently tried to comply with the law. If a change is necessary to prevent abuse, the burden of the change should fall on those abusing the system, not those who have acted responsibly.

Furthermore, the definition of crude oil under the energy regulations is arguably broad enough to cover all condensate without resorting to a theoretical calculation. Aminoil therefore requests that the proposed addition to the definition of crude oil either be stricken in its entirety or be revised so that any additional burden of compliance falls on those who abuse the system.

Your consideration of these comments and recommendations to H.R. 6056, the Technical Corrections Act of 1982, is greatly appreciated.

STATEMENT OF RACHELLE B. BERNSTEIN, SENIOR TAX ATTORNEY, TAX POLICY CENTER, CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA

On behalf of the Chamber of Commerce of the United States, representing over 240,000 business, trade association, and local and state chamber members, we welcome the opportunity to submit testimony on H.R. 6056, the Technical Corrections Act of 1982. The Chamber is particularly concerned with two sections of this bill: Section 102(j), dealing with the incentive stock option provision of the Economic Recovery Tax Act of 1981 (ERTA) and Section 102(h), dealing with the new incremental research and development credit provision of ERTA. Subsections 102(j)(6) and 102(h)(2) should be removed from H.R. 6056 and considered on their own merits as substantive legislation.

INCENTIVE STOCK OPTIONS

Section 102(j)(6) of H.R. 6056 makes a retroactive substantive change in law and, therefore, does not belong in a technical corrections act. Section 102(j)(6) would provide that where the disposition of stock acquired pursuant to the exercise of a statutory stock option (incentive, qualified, or restricted stock option) to acquire other stock in connection with the exercise of an incentive stock option occurs prior to the expiration of the applicable holding period, it will not be treated as a nonrecognition of income transaction under Section 1036 of the Internal Revenue Code.

This means that stock acquired upon exercise of an incentive stock option could not be used to exercise a further incentive stock option until after two years from the date of grant and one year from the date of exercise of the first incentive stock option. As to shares acquired on exercise of a qualified stock option and used to exercise an incentive stock option, a three-year holding period would be applicable.

In 1981, Congress specifically provided for the qualification of incentive stock options which permit the employee to "pay for the stock with stock of the corporation granting the option", under Internal Revenue Code Section 422A(c)(5)(A). By requiring long and varying holding periods for the use of stock acquired on exercise of statutory options and by repealing present law which excepts Sections 1036 exchanges from treatment as "dispositions", the proposed amendment would reverse the ERTA direction to permit stock-for-stock exercises. This cannot masquerade as a technical correction.

Section 102(j) is apparently intended to prevent "pyramiding"—the use of stock acquired on partial or full exercise of an option to acquire further stock under the same option. The Securities and Exhcnage Commission has reviewed this issue and has permitted pyramiding even though it was not originally contemplated in Rule 16b-3. Whether pyramiding is an evil which should disqualify a disposition from nonrecognition treatment is an issue which is subject to serious question and should be addressed independently on its own merits.

Moreover, the proposed amendment would be retroactive to the enactment of ERTA. Taxpayers have acted in good faith in reliance on the plain wording of present law. Taxpayers have already used stock acquired on the exercise of qualified stock options held for more than one year, but less than three, to exercise incentive stock options. Such taxpayers should not be retroactively penalized by the enactment of a prohibition which they could not ahve foreseen. The retroactive application of this provision raises basic issues of fairness and deserves careful study.

The Chamber urges that Subsection 102(j)(6) be removed form the proposed Technical Corrections Act and considered independently.

CREDIT FOR INCREASING RESEARCH EXPENDITURES

Section 102(h) of H.R. 6056 is also substantive legislation and does not belong in a technical corrections bill. Section 44F(b)(2)(A)(iii) of the Internal Revenue Code would be amended by Section 102(h) to provide that *in-house research expenses* would not include payments for the right to use personal property other than the use of computer time by persons other than the taxpayer and persons related to the taxpayer. Section 44F(b)(2)(A)(iii), as enacted by ERTA, provides that in-house research expenses include "any amount paid or incurred to another person for the right to use personal property in the conduct of qualified research."

The Conference Report accompanying ERTA stated that: "* * * research expenditures qualifying for the new incremental credit consist of (1) "in-house" expenditures for research, wages and supplies, plus certain lease or other charges for research use of computers, laboratory equipment, etc. * * *.

Thus, Section 102(h)(2) would make two substantive changes in the law: (1) the only rental charges that could be considered "in-house research expenses" would be amounts paid for the use of computers rather than for any personal property such as laboratory equipment, and (2) such computer charges would qualify only if the computer is principally used by third parties.

In introducing H.R. 6056, Representative Conable stated that "[t]he Technical Corrections Act of 1982 is not intended to provide a vehicle for reconsidering the substantive decisions made in the legislation being corrected." 128 Cong. Rec. H1394 (April 1, 1982). We fully agree with his statement.

Although the proposed change in the incremental research credit may be desirable as a matter of policy, it would substantively and substantially alter the law. The drafters of H.R. 6056 recognized this by providing that the new restrictive rule would apply only to amounts paid or incurred after March 31, 1982. The Chamber, therefore, also urges that Subsection 102(h)(2) of H.R. 6056 be removed from the proposed Technical Corrections Act of 1982 and considered separately on its merits.

As we receive comments from our members, the Chamber will be pleased to provide the Ways and Means Committee with further information as to potential problems resulting from H.R. 6056.

HOPKINS & SUTTER,
May 5, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: On behalf of the Chicago Board of Trade and the Chicago Mercantile Exchange, we are submitting this letter for the record in connection with H.R. 6056, the "Technical Corrections Act of 1982."

A troublesome issue under Title V of the Economic Recovery Tax Act of 1981 is the interaction of the rules relating to regulated futures contracts ("RFC's") and the rules relating to positions other than regulated futures contracts ("non-RFC's"). In general, capital gain and capital loss from RFC's is treated as 60 percent long-term and 40 percent short-term, and capital gain and capital loss from non-RFC's is entirely short-term (unless held for more than one year). RFC's are subject to annual mark-to-market taxation under Code Section 1256 while non-RFC's held as part of a "straddle" are subject to the rules of Code Section 1092 relating to the timing of loss recognition.

The Committee has under consideration two proposed technical amendments relating to the coordination of the RFC and non-RFC rules. A proposed amendment to H.R. 6056 would permit an election to treat foreign currency contracts in the same manner as RFC's. A second proposal, now contained in section 105(b)(2) of H.R. 6056, would amend the procedures for an effective "mixed straddle" election, under which a taxpayer can elect to exclude from the provisions of the Code Section 1256 RFC's combined in a straddle with non-RFC's.

Section 105(b)(2), as currently drafted, would have the unnecessary effect of disqualifying many traders from the mixed straddle election provisions. As a practical matter, many mixed straddles begin as all-RFC straddles. A trader will initially enter into a short RFC and an offsetting long RFC; later, the trader acquires a physical commodity by accepting delivery in satisfaction of the long futures contract. The bill may preclude identification of the physical commodity and the short RFC as a "mixed straddle" because the commodity was not identified on or before the day the short RFC was acquired.

The trader whose all-RFC straddle becomes a "mixed straddle" should be able to take advantage of the "mixed straddle" election. It may not be feasible economically for him to close out his existing short RFC and reestablish another short RFC to meet the technical "mixed straddle" election requirements being proposed. If the Committee wishes to avoid application of the "mixed straddle" provisions to gain or loss accrued on the short RFC *prior to the date* of acquisition of the physical commodity, that result could perhaps be achieved by considering the short RFC terminated (for purpose of Code Section 1256(c)) at the time the physical commodity is acquired and identified as part of a "mixed straddle."

Regardless of the Committee's action with respect to the two provisions mentioned above, many taxpayers will have straddles which will be considered to contain both RFC's and non-RFC's and which will not be covered by a "mixed straddle" election. Capital gain and loss on the RFC's will be 60 percent long-term and 40 percent short-term. Capital gain on the non-RFC will generally be entirely short-term. There is now great uncertainty as to whether, and under what circumstances, a portion of the capital loss on the non-RFC will be re-characterized from short-term to long-term. In formulating the rules in this area, any perceived abuses should be handled in a manner that will not leave legitimate investors and traders in a no-win situation—with gains on non-RFC's being short-term while losses on non-RFC's would be partly long-term. We urge that regulatory short sale rules (promulgated under Code Section 1092(b)), supplemented by any necessary technical Code amendments, avoid this potential whipsaw against legitimate economic activities.

Sincerely,

FREDERIC W. HICKMAN.
BRADFORD L. FERGUSON.

STATEMENT OF HERBERT B. COHN, CHAIRMAN, COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT

My name is Herbert B. Cohn. I am associated with the law firm of Morgan, Lewis & Bockius in Washington, D.C. I am presenting this Statement as Chairman of the Committee for Capital Formation Through Dividend Reinvestment, which has been a principal proponent of the dividend reinvestment legislation incorporated in Section 321 of the Economic Recovery Tax Act of 1981. A list of the members of our Committee as of April 23, 1982, is attached.

We urge favorable consideration of the "Amendments Related to Section 321" included in H.R. 6056 (at p. 29, 1. 22 through p. 30, 1. 25). We believe these amendments are highly desirable to provide further clarification of an ambiguity in Section 321.

That ambiguity arose out of the use, in defining "qualified public utility", of the term "public utility recovery property", with a cross-reference to Section 168 of the Internal Revenue Code. As used in Section 168, the term "public utility recovery property", for purposes of the accelerated cost recovery system, incorporates a requirement for normalization. This raised the question whether it was intended that the normalization requirement of Section 168 be applicable in determining eligibility under the dividend reinvestment provisions of Section 321. If it were applicable, the qualification of virtually all otherwise eligible dividend reinvestment plans could be in doubt.

It seems clear that this was not the Congressional intention. Statements to that effect by Chairman Rostenkowski and by Congressman Pickle, the original Congressional sponsor of the dividend reinvestment proposal, appear in the Congressional Record of August 4, 1981 (at p. H. 5983). In addition, the Internal Revenue Service addressed the question in a release dated September 28, 1981, and stated that "a public utility does not have to 'normalize' depreciation or cost recovery deductions in order to maintain a qualified dividend reinvestment plan." And the General Explanation of the Economic Recovery Tax Act of 1981, prepared by the Staff of the Joint Committee on Taxation (sometimes known as the "Bluebook"), also includes the statement that "It is not intended that the normalization requirement of Sec. 168(e)(3) apply" (at p. 218, n. 6).

However, because of the pervasive nature of the issue, it has been thought highly desirable to eliminate all doubts and resolve the question definitively by including an appropriate provision for the purpose in the technical corrections legislation.

We believe this has been done effectively in the "Amendments Related to Section 321" by eliminating the concept of "public utility recovery property" as defined in Section 168, and substituting the term "qualified long-life public utility property" with a definition which reflects the original Congressional intention.

Accordingly we urge favorable consideration of the "Amendments Related to Section 321" which appear at p. 29, 1. 22 through p. 30, 1. 25, of H.R. 6056.

COMMITTEE FOR CAPITAL FORMATION THROUGH DIVIDEND REINVESTMENT—MEMBERS AS OF APRIL 23, 1982

American Electric Power Company.
Baltimore Gas & Electric Company.
Boston Edison Company.
Brooklyn Union Gas Company.
Central Illinois Light Company.
Central Maine Power Company.
Central and South West Corporation.
Cleveland Electric Illuminating Company.
Dayton Power & Light Company.
Duke Power Company.
Edison Sault Electric Company.
Empire District Electric Company.
General Telephone & Electronics Corporation.
Iowa Electric Light & Power Company.
Iowa Resources, Inc.
Kansas-Nebraska Natural Gas Company.
Manufacturers Hanover Company.
Minnesota Power & Light Company.
Montana Power Company.
Northeast Utilities.
Orange & Rockland Utilities, Inc.
Pacific Power & Light Company.
Philadelphia Electric Company.
Portland General Electric.
Public Service Company of Colorado.
Puget Sound Power & Light Company.
Rochester Gas & Electric Company.
Washington Gas Light Company.
Wisconsin Power & Light Company.

CREDIT UNION NATIONAL ASSOCIATION, INC.,
GOVERNMENTAL AFFAIRS DIVISION,
Washington, D.C., April 30, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR CHAIRMAN ROSTENKOWSKI: The Credit Union National Association, Inc. (CUNA), representing over 20,000 credit unions through 52 state credit union leagues, submits this letter for inclusion in the record on your committee hearings on H.R. 6056, "The Technical Corrections Act of 1982".

Section 103 of H.R. 6056 states that Section 128(d)(5)(A) of the Internal Revenue Code is to be amended by adding credit union share accounts to the calculation of "qualified net savings". Section 128 of the Code pertains to All Saver Certificates which can be issued by qualified institutions between October 1, 1981 and December 31, 1982. Credit unions, "the deposits or accounts of which are insured under Federal or State law or are protected or guaranteed under State law," qualify to offer ASCs. This definition includes all of the federally and state chartered credit unions in the United States. Under Subsection 128(d)(4), therefore, all credit unions are exempted from the residential property financing test established for all other issuers of ASCs, and are subject to a special rule on the amount of ASCs they can issue. We question if credit union share accounts need to be added to Section 128(d)(5)(A) on the definition of "qualified net savings," since credit unions are not subject to the housing test. This change will have no meaningful application unless Congress decides to extend the All Saver Certificate program past December 31, 1982 and eliminate the special rule for credit unions under Subsection 128(d)(4). Therefore we do not feel this amendment is necessary in the Technical Corrections Act.

We believe that the amendments proposed in H.R. 6056 to the 1981 changes in the law governing individual retirement accounts will help clarify many of the questions raised by our credit unions. In particular we favor three of the proposed amendments. We support the revision which makes clear that a worker over the age 70½ can still make deductible contributions to his non-working spouse's IRA. The amendment to the definition of "compensation" resolves the many questions raised on whether funds received from pensions, annuities and deferred compensation plans can be contributed to IRA accounts. We also support the amendment which would revise the rule relating to rollover of lump sum distributions under qualified plans and tax-sheltered annuities to allow partial as well as total distributions of accumulated deductible employee contributions to be eligible for tax-free rollover treatment.

We thank the Committee for the opportunity to add our comments to the record on H.R. 6056.

Sincerely yours,

James C. Barr,
Executive Vice President and Director.

Statement of William L. Gehrig, Washington, D.C.

I am an attorney with the Washington, D.C. law firm of Ivins, Phillips & Barker, Chartered. I am submitting this statement on my own behalf but in consideration of all of the working taxpayers of this country who are affected by the proposed elimination of the 1.25 percent credit applicable for 1981 to the portion of their tax determined under the 50 percent maximum rate for personal service income (the "maximum tax").

There are three basic reasons why the proposed repeal of the 1.25 percent credit is unsound. First, the repeal unfairly discriminates against a large group of working taxpayers by denying them a large percentage of the 1.25 percent tax credit which is fully available to every other taxpayer for 1981. Second, the repeal is not applied consistently to maximum bracket taxpayers; it only affects those subject to the 50 percent maximum bracket and not those subject to the 70 percent maximum bracket. Third, an overall view of the tax cuts enacted last fall indicates that many of this country's successful working taxpayers will never receive their fair share of the "across the board" cuts. Consequently, it would be particularly inequitable to strip them of the modest benefit provided by the 1.25 percent credit in 1981. It is also submitted that even if the proposed repeal is enacted, those taxpayers who filed their returns in accordance with the law as it existed on April 15, 1982 should be given a reasonable amount of time to submit any balance due without the imposition of any interest or penalties.

I. If the 1.25 percent credit is repealed now, it will eliminate a credit to a group of working taxpayers which is fully available to every other taxpayer in 1981, including those taxpayers who receive large amounts of passive income. The following example illustrates the comparative tax benefits inuring to a married working couple earning a combined taxable income of $90,000 and another married couple reporting the same taxable income from interests and dividends on their $1,000,000 inheritance:

	Working couple	"Passive" couple
1980 tax	$34,678	$36,098
1981 tax under ERTA	34,245	35,647
1981 tax after ERTA (if amended)	34,432	35,647
Percent change from 1980 to ERTA	1.25	1.25
Percent change from 1980 to ERTA (If amended)	.70	1.25

This example illustrates that on a percentage basis passive income recipients will be almost twice as well off as the working taxpayer under the proposed amendment. This difference becomes even greater as the income of these taxpayers increases. For example, if the working couple is very successful and earns a combined taxable income of $200,000, they are more than three times worse off on a percentage basis than the passive income couple reporting the same taxable income from dividends and interest on their $2,000,000 inheritance:

	Working couple	"Passive" couple
1980 tax	$89,768	$107,032
1981 tax under ERTA	88,646	105,694
1981 tax under ERTA (if amended)	89,432	105,694
Percent change from 1980 to 1981 ERTA	1.25	1.25
Percent change from 1980 to 1981 ERTA (if amended)	0.37	1.25

II. Another inequitable aspect of this proposed repeal is that it only applies to the 50 percent maximum tax bracket and not the 70 percent maximum tax bracket. Thus, the couple receiving passive income in excess of $215,400 in 1981 obtains the credit against the tax imposed on every dollar received in excess of $215,400, while for the working couple, the credit disappears for tax owed on any amounts earned in excess of $60,000. The "passive income" couple also receives the full credit on the tax on amounts between $60,000 and $215,400.

How can these results possibly be consistent with the basic policy objective of the Economic Recovery Tax Act, i.e., to rejuvenate this country's economy by cutting taxes and providing incentive to working people to be more productive? Certainly the successful working taxpayers of this country are excellent examples of its productive members. Why are they singled out and penalized relative to everyone else, and particularly, those who generate substantial amounts of income from passive sources?

III. An overall look at the series of individual tax cuts which were enacted last fall makes clear that the working taxpayers in the maximum tax brackets were treated shabbily in comparison to all other taxpayers. The so-called cumulative "across the board" tax cuts of 1.25, 10, 19 and 23 percent are only partially available to the working taxpayers whose income will exceed the old maximum tax bracket amounts ($60,000 on a joint return; $34,200 on an individual return). For example, the married working couple who together earned $90,000 in both 1980 and 1982 will experience only a 6.6 percent drop in their taxes in 1982:

Working couple

1980 tax	$34,768
1982 tax (ERTA)	32,449
Percent decrease (percent)	6.6

Indeed, the only tax break available to married taxpayers in 1982 on their income in excess of $60,000 is a reduction in the marginal rate from 50 percent to 49 percent on amounts between $60,000 and $85,600. Meanwhile, the married couple who reported taxable incomes of $90,000 for 1980 and 1982, but whose income was derived solely from dividends and interest, experience a drop of approximately 13 percent:

"Passive" couple

1980 tax	$37,284
1982 tax (ERTA)	32,449
Percent decrease (percent)	13

This precentage differential increases as the amount of taxable income increases for each couple. Thus, the married working couple who after careers of outstanding service earn $200,000 a year obtains a paltry 1.5 percent drop between 1980 and 1982. On the other hand, a couple collecting $200,000 in dividends and interest from their $$2,000,000 inheritance experiences a drop of 22.7 percent due to the 10 percent tax cut and the reduction of the maximum rate from 70 percaent to 50 percent. It is ironic, to say the least, that the fundamental force behind the Economic Recovery Tax Act, a desire to spur economic productivity, does so much for the passive income collectors and so little for some of the proven producers of this country. Certainly this divergent treatment supports the retention of the modest benefit afforded working people by the 1.25 percent credit in 1981.

IV. This proposed change in the tax law would be enacted retroactively after thousands of taxpayers have paid estimated taxes and filed returns in good faith under the clear provisions of the Economic Recovery Tax Act of 1981. While the Internal Revenue Service forms were modified in anticipation of this proposed amendment to ERTA, the forms were not prepared with congressional authorization. It was by no means clear to taxpayers who were aware of the law in effect on April 15, 1982 that the proposed amendment would retroactively alter their tax liability. There is also, of course, no legal obligation on a taxpayer's part to pay income taxes as proposed in pending legislation, rather than is required by statute. Accordingly, even if the proposed amendment eliminating the 1.25 percent credit is ultimately passed, those taxpayers who conformed to the requirements of the law which were in effect on April 15, 1982 should not be assessed any penalty or interest amounts if any tax is owed as a result of the elimination of the credit. This would also conform with Service's practice in the past when dealing with tax laws which have been amended retroactively. See, e.g., T.D. 6154, 1955-2 C.B. 237.

As a final note, recent budget talks indicate that an income tax surcharge in the range of 4 percent may well be charged against the higher income bracket taxpayers of this country. The overall effect to the working taxpayers in this group would be to wipe out the ERTA cuts completely and raise their tax rates above the rates which were in effect before the changes made under ERTA. Elimination of the 1.25 percent credit for 1981 coupled with the imposition of a 4 percent surtax for 1982 causes the taxpayer whose earned income puts them in the 50 percent bracket to wonder why they are singled out as the one group entitled to no benefits from the reductions but all burdens from tax increases. Because this group is working and earning money, rather than lobbying, it becomes the ultimate loser in the pending tax legislation.

STATEMENT OF DAVID G. HARRIS, UNIVERSITY OF TEXAS, ARLINGTON, TEX.

POTENTIAL NEGATIVE IMPACT OF THE NEW 24-MONTH ROLLOVER OF GAIN ON PRINCIPAL RESIDENCE

The Economic Recovery Tax Act of 1981 (hereinafter referred to as ERTA) (P.L. 97-34) made an important change in the time period within which one must replace a principal residence following a sale of such residence in order to "rollover" or defer the gain on the sale (I.R.C. Sec. 1034). Under the rules prior to the enactment of ERTA replacement of a principal residence within an 18 month period preceding or following the sale of that residence was required unless a new residence was being constructed. In the latter case, construction would have to have commenced within 18 months and have been completed within 24 months of the sale. Under the new rules, one has a 24 month period before and after the date of the sale in which to purchase or construct a new residence. This law is directly applicable to sales of principal residences taking place after July 20, 1981 (the date these provisions were first made public). However, the 24 month replacement period is also effective for residences sold prior to July 21, 1981 if the rollover period previously in effect (18 months) had not yet expired as of July 20, 1981. This provision can cause anomalous results for the unwary.

By extending the replacement period, Congress retroactively modified the tax treatment of a large number of taxpayers. At first glance, this would appear to be all to the good. However, for many persons who did not benefit from the extension of time, this change in the law may have an unintended negative impact.

As one may replace a residence within the 24 or 18 month period from the date of sale, so one may apply this tax-free rollover only to the last principal residence purchased. If an individual purchases, sells and then repurchases another residence within the prescribed time period, then the middle residence does not receive favorable tax treatment. ERTA, by extending the replacement period to 24 months, has created an impediment to the sale and replacement of a residence by any person who had sold a principal residence and replaced it prior to the enactment of ERTA and whose 18 month rollover period had not expired as of July 20, 1981.

A simple example should serve to illustrate this situation. If a taxpayer purchased his or her first residence in 1969 for $30,000, sold it in May 1980 for $75,000 and purchased a second residence in August 1980 for $100,000, then the basis in the second residence would be $55,000 ($100,000 purchase price less the deferred gain on the first sale of $45,000). The 18 month holding period, absent ERTA, would have run out in October 1981 and the taxpayer would be free to purchase a new principal residence. However, under ERTA, the taxpayer would be unable to buy this last residence until May 1982 without losing the rollover benefits for the second home. In this example, the taxpayer derived no possible benefit from the change as he had actually replaced his residence before July 20, 1981, but has instead been exposed to an unforeseen liability in the event he relies on the old rules.

If a person had sold a house and had replaced it prior to July 20, 1981, then that person will have to postpone purchasing another principal residence for an additional six months or any gain on his current residence (not including the rollover gain) will be recognized and not deferred or rolled over. However, with a certain amount of planning, one may mitigate this result.

Under I. R. C. Sec. 1034, if a person purchases a second principal residence within the rollover period after the sale of the old residence, then only the second residence will qualify under the deferral rules and the gain on the intervening home will have to be recognized. One may have the deferral rules apply to the intervening home if the purchase of the second is delayed until after the replacement period on the old home has expired. This leads to the result that the intervening home may be sold at any time, so long as the purchase of a replacement is delayed. Once the intervening home is sold, one has a 24 month period in which to replace it. The conclusion that follows is that if one wishes to enjoy the rollover benefits one must either delay the sale of the current home, or sell and delay the purchase of a replacement home and rent in the intervening time period.

An obvious planning possibility would be the renting of a home with the option to buy. To make such an arrangement in a typical home sale, one would have to provide a great deal of security to the seller. This raises an additional hazard—that the IRS may reconstruct the date of sale to the date the property changed hands rather than the contract date. Pursuant to Rev. Rul. 69-93, 1969-1 CV 139 and leading cases in this area the elements that determine the date of sale are: (1) the date of transfer of possession, (2) the date of the transfer of the risk of loss, and (3) the date specified in an irrevocable contract. If one wishes to convert an ordinary house sale into a lease-purchase, these elements must be carefully managed. Of course, the contract would state that there was a "lease-purchase" with a deferred closing date, but if the physical possession and risk of loss changed hands on a particular date, as well as the payment of a substantial, non-refundable deposit or down-payment then it would be less difficult for the IRS to show the actual sale date to be the earlier rather than the later date. This difficulty is especially acute as the items indicated above are provisions the average, non-investor, seller would desire. The homeowner would probably need the down payment to purchase a new residence for himself and would not normally want to share in any risk of loss continuing after the date of sale. Finally, such lease with a purchase option could cause the seller to lose the availability of I. R. C. Sec. 1034 for his or her own benefit.

Congress has taken notice of the above situation. Representative Rostenkowski and ranking minority member Barber Conable introduced a Technical Corrections Bill of 1982 (H.R. 6056) on April 1, 1982. Pursuant to this proposed amendment, any person who had sold a residence prior to August 13, 1982 (the date ERTA provisions became law) could elect out of the ERTA extended rollover provision. This would effectively reinstate the prior rules for such sales and mitigate the negative impact of the ERTA in this area. But, one must ask if this change really represents a mere technical or clerical change, as opposed to a substantive change in the law.

If it were merely Congress' original intent, in passing the revision of I.R.C. Sec. 1034, to increase the time period for rollovers from 18 to 24 months without detrimentally affecting any taxpayers, then the proposed amendment is overly broad. To the extent a taxpayer could knowingly benefit from the 24 month period then it follows that he should assume the attendant burdens. One must first determine which taxpayers could derive a benefit from the extension. In this case taxpayers who had sold a residence and had not replaced it prior to July 20, 1981 would be in a position to knowingly benefit from the change in the law by postponing the replacement for an additional six months. On the other hand, persons who had sold and had replaced their residence prior to July 20, 1981 could not possible enjoy any benefit from ERTA. It therefore follows that the correction of ERTA should allow an election of the old rules only for those taxpayers who had sold and had replaced their residence prior to July 20, 1981 and not for any taxpayers who had sold and had not yet replaced their residence on that date. Only the former and not the latter would be exposed to a detriment without any corresponding benefit. The amendment as currently drafted, would allow any person who had sold such a residence to elect the new or old rules whether or not that person had replaced their residence prior to July 20, 1981.

Submission of the International Harvester Co.—The Safe-Harbor Lease-Leaseback Between International Harvester Co. and Chris-Craft Industries, Inc.

SUMMARY

On August 31, 1981, International Harvester Company ("Harvester") leased certain equipment acquired by Harvester between January 1, 1981 and August 31, 1981 to a subsidiary of Chris-Craft Industries, Inc. ("Chris-Craft") which simultaneously subleased the equipment back to Harvester. The sole purpose of the transaction was to take advantage of the Internal Revenue Code's safe-harbor leasing provisions (added by the Economic Recovery Tax Act of 1981 on August 13, 1981) to transfer investment tax credits from Harvester to Chris-Craft. The transaction had to be completed by August 31 because it was the last day of Chris-Craft's fiscal year and because Harvester was experiencing serious financial problems at that time.

The parties structured the transaction as a lease-leaseback in reliance on a definitive colloquy between Senators Dole and Danforth specifically approving lease-leaseback transactions under new Code § 168(f)(8). On October 20, 1981 (nearly two months after the transaction), the Treasury and IRS announced that they had not determined whether they would approve lease-leasebacks under the safe-harbor leasing provisions.

Harvester and Chris-Craft reasonably relied on explicit congressional pronouncements approving the form of the transaction. The parties were required to act quickly—before any of the controversy over safe-harbor leasing arose and before the temporary regulations were issued on October 20, 1981—and placed heavy reliance on the colloquy between the Chairman and a leading member of the Senate Finance Committee. It is now too late for Harvester and Chris-Craft to recast their transaction.

To the best of Harvester's knowledge, no other lease-leasebacks have been consummated under the safe-harbor leasing provisions.

FACTS

On August 31, 1981, Harvester leased certain equipment acquired between January 1, 1981 and August 31, 1981 to a subsidiary of Chris-Craft which simultaneously subleased the equipment back to Harvester.

The terms of the lease-leaseback agreement (the "Agreement") were designed to quality as a safe-harbor lease under § 168(f)(8) of the Internal Revenue Code, added by the Economic Recovery Tax Act of 1981 ("1981 Act") on August 13, 1981. The sole purpose of the Agreement was to transfer investment tax credit ("ITC") with respect to the equipment from Harvester to Chris-Craft. Harvester retained title to and all benefits, burdens, obligations, liabilities and incidents of ownership and use with respect to the equipment, except ITC. The net rent receivable by Harvester was designed to compensate it for the ITC transferred to Chris-Craft.

The parties entered into the Agreement within three weeks after the 1981 Act was signed, relying upon a colloquy in the Congressional Record between Senator Dole, the Chairman of the Senate Finance Committee, and Senator Danforth, a leading member of that Committee, expressly approving safe-harbor leases in that form. Prompt consummation of the transaction was compelled as to Harvester by its adverse income and financial position, and as to Chris-Craft because its tax year ended on August 31. To confirm the tax results, on October 8, 1981, Harvester and Chris-Craft filed a joint request for a favorable IRS ruling.

Subsequently, in October 20, 1981, the Treasury promulgated temporary regulations that reserved comment on lease-leasebacks of the type already entered into by Harvester and Chris-Craft. On December 28, 1981, the IRS released Revenue Procedure 81-10 stating that it would not issue rulings on the tax consequences of lease-leasebacks under Code § 168(f)(8). This Revenue Procedure by its terms applied to the Harvester-Chris-Craft joint ruling request, although the IRS has so far neither ruled nor declined to rule on such request. Thus, to date the IRS has not approved a legitimate transaction enterd into on the basis of clear legislative history at a time when the parties had no reason to foresee a contrary tax result.

THE AGREEMENT QUALIFIES AS A SAFE-HARBOR LEASE

The Harvester-Chris-Craft Agreement qualifies as a safe-harbor lease under Code § 168(f)(8) for the following reasons:

1. *Harvester and Chris-Craft relied on authoritative Congressional pronouncements specifically allowing lease-leasebacks.*—In entering into the Agreement, Harvester and Chris-Craft relied on the pronouncements of Senators Dole and Danforth (Con-

gressional Record, Senate at S8644, July 28, 1981) in a colloquy under Code § 168(f)(8) specifically permitting lease-leasebacks:

Senator DANFORTH. It is my understanding that the amendments make it clear that the policy of facilitating use of the investment tax credit through leasing pursuant to the safe harbor rules applies equally to so-called credit pass-through leases. In these instances, property is leased to a lessor who then subleases the property back to the original lessor or an affiliate. The credit is passed pursuant to a section 48(d) election to the lessee-sublessor, who would be treated a (sic) the lessee for purposes of the Code. The original lessor or an affiliate obtains the benefit through the relative rentals under the lease and sublease. (Emphasis added)

Senator DOLE. The understanding of the Senator is correct.

Harvester and Chris-Craft reasonably relied upon this dispositive legislative history at the time they entered into the transaction and structured the Agreement as a lease-leaseback.

One commentator has suggested that even though the Treasury has reserved decision on the validity of lease-leasebacks, the legislative history is sufficiently compelling to justify proceeding with a transaction at this time. Hahn, Transferring Deductions and Credits under the Economic Recovery Tax Act of 1981—The Special Rules for Leases, 59 Taxes 963, 975 (1981). Whatever the result for transactions entered into at this time in the face of Treasury reservations, transactions entered into prior to the temporary regulations should qualify as safe-harbor leases.

2. *Business exigencies required that the parties act before IRS or Treasury ratification of the legislative intent was issued.*—Both Harvester and Chris-Craft were required to act before the end of August. Harvester was experiencing serious income and financial problems at the time and believed that an immediate safe harbor lease was necessary. Chris-Craft's fiscal year ended August 31 so that it had to enter into the Agreement by that date in order to take advantage of Code § 168(f)(8) for its 1981 fiscal year. Neither party had the good fortune to be able to sit back and wait for the expected IRS and Treasury confirmation of the clear legislative history; immediate action based on clearly-expressed Congressional intent was required.

3. *The parties are now foreclosed from entering into a comparable transaction.*—It is now too late for Harvester and Chris-Craft to seek comparable safe-harbor leases that qualify under the temporary regulations. Harvester's fiscal year ended October 31 and the 90 day grace period has long expired. It cannot now transfer to any other purchaser the ITC transferred to Chris-Craft. As noted above, Chris-Craft's fiscal year ended August 31.

The Agreement calls for Chris-Craft to pay Harvester $25,625,000 over five years, but only $1,000,000 should the Agreement not be approved by May 31, 1983. These are very important potential payments for Harvester given its current financial position. In this connection, we believe that the Harvester-Chris-Craft transaction represents the only lease-leaseback consummated under the 1981 Act.

Harvester and Chris-Craft believe that the Agreement fits within both the letter and the spirit of Code § 168(f)(8).

STATEMENT OF JACK M. KINNEBREW, DALLAS, TEX.

SUMMARY OF PRINCIPAL POINTS

I. Section 2032A provides that if a return was filed late, after all extensions expired, the current use valuation could not be adopted regardless of the reason for the late filing. The loss of the current use valuation resulted in an irreversible and unjust tax penalty merely for the filing of a late return.

II. The Economic Recovery Tax Act of 1982 eased the election process but did not give relief to those estates which suffered the unjustice of prior law and serviced to bring the error of prior law to the attention of Congress.

III. During the period from the adoption of Section 2032A until the adoption of final regulations under the Section in 1980, a state of confusion has existed regarding the availability of the current use valuation. Estates of decedents which were required to make an election under Section 2032A during this period should not be penalized for the uncertainty surrounding special valuation.

IV. Congress should permit the retroactive application of Section 2032A to all estates of decedents dying after December 31, 1976 which elected the current use of their first-filed returns. For those estates for which the statute of limitations has closed, but which evidenced their desire to adopt the current use value on their first-filed returns, Congress should provide an appropriate amount of time during which the current use valuations may be elected.

V. No windfall will accrue to any estate, the tax effect on revenue is negligible, and administrative difficulties should be minimal because of the narrow range of estates which could retroactively apply the current use valuation.

STATEMENT

My name is Jack M. Kinnebrew. I am a partner in the law firm of Strausburger & Price, 1200 One Main Place, Dallas, Texas. I am testifying as an individual. As a matter of information only, for the past two years I have been serving as Subcommittee Chairman of a Committee on Section 2023A within the Estate and Gift Tax Committee of the Tax Section of the American Bar Association.

I am testifying today in support of H.R. 5342, a bill introduced by Congressman Fields, to rectify an existing inequity under the special use valuation provisions of the Code. Section 2023A(d)(1) was just amended by the Economic Recovery Tax Act of 1981 ("ERTA") to allow the special use valuation provisions of Section 2023A to be elected on a late-filed return, provided the return is the first filed by the estate. Yet it applies only to the estates of decedents dying after December 31, 1981. The estates of decedents dying on or before December 31, 1981, are not permitted to benefit from the new election provisions. This, in my opinion, is both unjust and inconsistent with the policy and intent of Congress effectuated by the adoption of Section 2023A. The bill which has been introduced makes the provisions of Section 2023A(d)(1) retroactive to the time when Section 2023A was enacted. Thus, the provisions will apply to the estates of decedents dying after December 31, 1976 and will remove the inequity which now exists.

The Congress adopted Section 2023A because it believed it inappropriate to value certain land for estate tax purposes on the basis of its highest and best use. A highest and best use valuation discouraged the use of property for farming and other small business purposes. The higher valuation of the property would lead to a greater tax burden which, in many cases, made the continuation of the farming or business actvities impossible. Sufficient funds to pay the tax imposed was unavailable in many cases. Frequently, the heirs were forced to sell the property in order to meet the tax burden. Section 2023A, a relief provision designed to remedy this harsh result, provided that estates meeting various substantive qualifications could adopt the current use value of the real property of the estate.

Nevertheless, this relief provision had hidden in its provisions a stumbling block. In order to benefit from the provisions of Section 2023A, the election to utilize the current use value had to be made on a timely filed estate tax return. Therefore, if a return was filed late, after all filing extensions expired, the current use value could not be adopted regardless of the reason for the late filing. The loss of the current use valuation election resuted in an irreversible and unjust tax penalty merely for the late filing of a return.

Congress, in ERTA, realized the error in the prior law and set out to remedy the harsh rule. ERTA eased the election process by allowing an election of the current use valuation on a late-filed return, provided the election is evidenced on the first-filed return. Nevertheless an injustice still exists. The revised election procedure applies only to estates which suffered the injustice of the prior law and served to bring the error to the attention of Congress were given no relief. This is an injustice which Congress should address and remedy.

During the period from the adoption of Section 2023A until today a state of confusion regarding current use valuation has existed in many areas of the United States. For example, the problem involving the gross cash rental requirement caused great difficulty for many family farmers. In most midwestern states, since little farmland is cash rented, the appraisers had extreme difficulty locating comparable cash leases. Many estates were therefore hard pressed to complete a timely filed election due to valuation difficulties and questions of their eligibility to so elect.

Regulations regrading Section 2023A were not helpful to the farmers and advisors who had to deal with the current use valuation issue. It was not until July 13, 1978, that the Treasury issued proposed regulations for Section 2023A, and then for only a few of the areas under that Section. On September 10, 1979, a portion of the proposed regulations was withdrawn, causing further consternation with regard to current use valuation qualifications and procedures. It was not until July 28, 1980, that any regulations under Section 2023A were finally adopted. The estates of farmers, ranchers and small businessmen which were in administration during this four-year state of confusion deserve the chance to benefit from the provisoins that Congress, in 1976, intended these very estates to utilize. They should not be penalized by the uncertainty and confusion which existed during the early years of Section 2023A when little guidance was supplied by the Treasury.

The defective election provision has existed since the inception of Section 2032A in 1976. In order to serve equity for all estates affected by the harshness of the prior election procedure, Congress should permit the retroactive application of Section 2032A(d)(1) to all estates of decedents dying after December 31, 1976, the effective date of Section 2032A. For those estates of decedents for which the statute of limitations is closed, Congress should provide an appropriate amount of time after the enactment of this bill during which those estates may apply for credits or refunds. Currently ERTA provides that for certain retroactive provisions, the statute of limitations will open for six months after the date of enactment of ERTA. This same opportunity should be given to those estates who failed to timely file in order to elect Section 2032A under prior law.

The breadth of such a retroactive application is lessened when one considers that only an estate which elected current use valuation on the estate's first return but which failed to file a timely return will benefit. It is this narrow range of decedent's estates whose heirs have been harmed by the prior defective law. We do not propose to permit all estates the chance to reevaluate and determine whether current use valuation would have been in their best interest. No windfall can be gained by the retroactive provision that is proposed. I ask only that those estates of small businessmen, farmers, and ranchers which desired the current use valuation (and which illustrated such desire on their first-filed tax return) but for which a timely return was not filed be given a fair opportunity to so elect. The administrative difficulties in handling the retroactive application should, therefore, be minimal. The effect on revenue is negligible.

The House Committee Report on ERTA accompanying the election provision amendments to Section 2032A states, "The Committee believes that qualified heirs should not be deprived of the benefits of current use valuation solely because the decedent's estate tax return is filed after the date on which it is due". House Committee Report on P.L. 97-34. This statement reflects that Congress is aware that the prior election provision under Section 2032A was defective. Qualified heirs should not be deprived of relief from the erroneous provision merely because the decedent died on or before December 31, 1981. The equities which brought about the changed in the election procedure lean even more heavily in favor of those qualified heirs who have already been harmed by the defective election procedure.

I urge the House Ways and Means Committee to incorporate the provisions of H.R. 5342 in its consideration of H.R. 6056, the Technical Corrections Act of 1982.

MURPHY OIL CORP.,
LAW DEPARTMENT,
El Dorado, Ark., April 29, 1982.

Re proposed definition of "crude oil" in H.R. 6056, the Technical Corrections Act of 1982.

Congressman BERYL ANTHONY,
Cannon House Office Building,
Washington, D.C.

DEAR CONGRESSMAN ANTHONY: Please consider this letter as Murphy Oil Corporation's comments on the above referenced provision of The Technical Corrections Act of 1982 (H.R. 6056). Additionally, it is our understanding that as announced at the House Ways and Means Committee meeting on H.R. 6056, held April 27, 1982, the public record on this matter will be kept open through April 30, 1982. We would certainly appreciate it if you would cause to be filed in said public record one of the enclosed copies of these comments.

The only provision to which these comments are addressed is found at lines 7-12 on page 56 of H.R. 6056.

"(2) Paragraph (1) of section 4996(b) (defining crude oil) is amended by adding at the end thereof the following new sentence: 'Such term includes condensates recoverable from natural gas (whether or not recovered before the natural gas is removed from the premises).' "

Murphy believes that this seemingly innocuous amendment is in reality an extremely complex and controversial issue that involves changes in fundamental statutory concepts of the Windfall Profits Tax. As such, we do not believe that Congress should pass the bill in a hurry-scurry manner under the guise of a "technical correction". Rather, we would urge the Congress to carefully review the diverse and complex issues involved, with the ultimate goal of formulating a full informed and appropriate definition of crude oil. If time pressures prevent giving this matter the careful scrutiny it deserves, then this provision should be deleted until adequate consideration may be given it.

Murphy is unfortunately unable at this time to offer a substitute definition which would solve all problems. However, the following areas should be addressed before Congress legislates its solution. First, and of most importance to Murphy, is the proposal's concept of "recoverable" condensates. The DOE regulations which were incorporated into the WPT subjected only certain liquids that were actually recovered to price controls, and in turn to windfall profits tax. Thus, the recoverable portion of the provision is a new legal concept which raises many complex questions. For example, what standards will be applied in measuring what is recoverable? Is necessary measuring equipment in place and if not what will be the cost to the industry? Will the concept be applied retroactively to March 1, 1980? Will there be consideration given in cases where the entire gas stream is sold by a producer at the wellhead and the producer actually recovers no condensate or other liquids?

Other areas involved with this matter and which should remove it from a "technical correction" type of legislation include the possibility that the proposal will subject some natural gas to duplicate federal regulation (Natural Gas Policy Act and Windfall Profit Tax), and the very real administrative problems facing some tax payers in such areas as trying to determine which producers are liable for which portions of the tax. Also, it would seem that this proposal may penalize investments in sophisticated natural gas processing plants that extract larger portions of natural gas liquids such as propane, but which recover a smaller total portion of a natural gas stream as condensates. Since important public benefits are achieved through enhanced propane production (agricultural use, petrochemical feedstock, etc.) the Congress should carefully consider the possible detrimental effect this proposal would have on these benefits.

To conclude, we urge the Congress not to hurriedly adopt this proposal due to time constraints but to carefully consider all of its ramifications. Thank you for the opportunity to submit our views on this matter.

Respectfully submitted.

W. BAYLESS ROWE.

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS, INC.,
Washington, D.C., April 30, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means,
House of Representatives, Washington, D.C.

DEAR CONGRESSMAN ROSTENKOWSKI: We are writing to request that this letter be included in the record relating to H.R. 6056, the Technical Corrections Bill of 1982. The letter expresses the grave concern of the National Association of Real Estate Investment Trusts, Inc. ("NAREIT") and the REIT industry [1] regarding computation of REIT earnings and profits under section 206 of the Economic Recovery Tax Act of 1981 ("ERTA" or "Act").

We believe that section 206 inadvertently obstructs the efforts of REITs to raise capital for investment purposes, a consequence that is inconsistent with the basic purposes of the Act. This obstructive effect in turn arises because the new earnings and profits rules unfairly discriminate between the real estate investor who holds an interest in property through the REIT vehicle and those who own property directly or through a partnership. Additionally, the Act actually may raise the total tax burden imposed on a REIT and its shareholders over that existing under prior law.

In more specific terms, we believe that, as a result of the requirement that for earnings and profits purposes a REIT must compute depreciation of its real property on the basis of a thirty-five year useful life:

(1) REITs are seriously disadvantaged in competing for real estate investment capital, particularly with respect to syndicated real estate partnerships. Largely because of their special tax status, REITs must look to external sources for capital, and the investment incentives of the Accelerated Cost Recovery System ("ACRS")

---

[1] NAREIT has among its membership 75 "tax qualified" real estate investment trusts, with assets of 5.3 billion dollars, comprising 80 percent of the assets of all qualified REITs. Other NARIET members include some 180 nonqualified REITs, leading law and accounting firms, and other organizations actively involved in the REIT industry.

are meaningless in this context. At the same time, the ACRS benefits are fully available to real estate investors who elect the partnership form.

(2) The investor who holds or acquires a share of real estate assets through investment in a REIT is unduly deprived of tax incentives available to his counterpart who acquires real property directly or in partnership with others. The degree of deprivation is inconsistent with the REIT enabling legislation.

(3) As many REITs acquire increasing amounts of property depreciable under ERTA, their investors will find that each REIT will have a steadily decreasing capacity to distribute some cash flow as a return of capital attributable to depreciation. Moreover, the investors will find that, when a REIT disposes of ACRS property, they and the REIT will experience a form of double taxation. This result is contrary to conduit concepts that are fundamental to REITs.

OPERATION OF THE 1981 ACT AS TO CAPITAL COST RECOVERY ON REAL PROPERTY AND COMPUTATION OF EARNINGS AND PROFITS BY CORPORATIONS (INCLUDING REIT'S)

As you know, the Act greatly changed the methods of computing depreciation of real property, particularly the permissible useful lives of such property applicable for depreciation purposes.

Under the Accelerated Cost Recovery System, the standard useful life of real property for purposes of computing depreciation was set at fifteen years. By adopting a considerably shorter useful life, Congress accelerated capital cost recovery by real property holders, including corporations and REITs. In the main, this step should act to enhance capital formation. However, Section 206 of the Act amended section 312(k) of the Internal Revenue Code to provide that for purposes of computing the earnings and profits of U.S. corporations, real properties are to be treated as if depreciated using the straight-line method over on extended recovery period of thirty-five years.

Under the law in effect prior to the Act, earnings and profits were computed as if straight-line depreciation had been taken over the useful life of depreciable property (including real property), regardless of the method of depreciation used in computing corporate income. No specific recovery period (useful life) was mandated for this computation, however.

The method of computing earnings and profits is vitally important because distributions by a corporation (or REIT, whether in corporate or business trust form, since all REITs are treated as corporations for this prupose) to its shareholders are taxable as dividends only to the extent such distributions are from current or accumulated earnings and profits. Under prior law, earnings and profits were reduced by an amount equal to straight-line depreciation. A REIT could make distributions to its shareholders equal to earnings and profits (before reduction for depreciation) plus an amount equal to the depreciation taken, and the depreciation element of the distribution would be a taxfree return of capital. The thirty-five year extended recovery period mandated by the Act for earnings and profits purposes is a longer useful life than that presently used on many properties on which "component" depreciation is computed. Use of this longer useful life on a property will, of course, decrease the annual straight-line depreciation deduction, causing earnings and profits to be larger than they otherwise would have been, and the taxfree return of capital in a given distribution to be smaller than under prior law.

The new rules in the Act will be devastating for REITs which routinely make distributions to shareholders which are large in relation to earnings and profits, and which consist of substantial "returns of capital". For a number of REITs, the "return of capital" component is crucial to the marketability of new REIT shares and the ability of those REITs to raise new capital in the future.

The "return of capital" distributions are essential to REITs in assuring a competitive real rate of return to their investors and in maintaining share prices at levels that are not excessively below the values of underlying real estate assets.

These factors are in turn vital to development of the record of performance that will attract future investment capital at reasonably affordable costs.

In summary, application of the new earnings and profits rules will in practical terms, as to many REITs and their shareholders, have the effect opposite of what was the intent of Congress in the Act, namely, the liberalization of capital cost recovery provisions as to depreciable assets and the stimulation of new investment through enhanced capacity to accumulate capital.

COMPETITION IN THE CURRENT REAL ESTATE MARKETPLACE

Today, REITs must compete for investment capital with other forms of real estate investment, particularly large real estate limited partnership syndications. Although generally sold in larger investment units than the average REIT share investment, syndicated partnerships nonetheless compete for funds from both small and large investors.

While investors in such entities do not enjoy the liquidity of investment that an investor in REIT shares has, the federal income tax treatment of partnerships provides significant tax advantages. These advantages were dramatically enhanced when ERTA introduced the 15-year cost recovery period and other incentives for real estate investment.

The extended recovery period provisions of section 312(k) are of course inapplicable to partnerships, and the full ACRS cost recovery benefits pass through to partners undiluted by any mandatory recomputation of depreciation on the basis of a thirty-five year useful life. Distributions of cash flow from a partnership attributable to depreciation deductions will reflect only the 15-year ACRS life.

The unrestricted benefits available to partnership investors stands in stark contrast to the decreased capacity of REITs to make return of capital distributions attributable to depreciation. The investment incentives of ERTA serve to make real estate partnerships much more attractive to a large portion of the spectrum of potential real estate investors. At the same time, section 206 of ERTA actually reduces the incentive for investment in REITs by imposing the thirty-five year useful life and reducing the capacity for return of investment to REIT investors.

It is this inequality in treatment of depreciation that will have a devastating impact on the ability of a number of REITs to raise new capital in the financial marketplace. REITs have in the past made "returns of capital" to shareholders, attributable to depreciation, because of the need to compete with other investment vehicles. It is those "partial returns of capital" which permit REITs to later raise additional capital through offerings of new shares at prices that are fair to the existing REIT shareholders.

Without the capacity to make such distributions to a degree that corresponds to the pass-through opportunities of partnerships, many REITs will be seriously harmed and some will find that effective competition for new capital will be virtually impossible. As REITs become increasingly disenfranchised, the remaining small investors having no access to partnerships will be prejudiced and the universe of real estate investors will be disserved by the narrowing of investment opportunities.

REIT'S AS DISTINGUISHED FROM BUSINESS CORPORATIONS GENERALLY

Although we understand the concern of the Congress in enacting the earnings and profits rule to prevent business corporations from sharing ACRS benefits with their shareholders, we believe that real estate investment trusts as a group merit different treatment under section 312(k) of the Code.[1] First, distributions by business corporations engaged in manufacturing, for example, differ substantially in scope from those in the REIT industry. A typical manufacturing company with publicly traded securities might distribute less than half of its annual earnings and profits as dividends to shareholders. It would be most unusual for such a manufacturing company to distribute all of its earnings and profits as dividends, much less to distribute net cash flow attributable to depreciation. Publicly-held manufacturing companies meet a substantial part of their capital needs through retained earnings and depreciation. For such companies, the shorter useful lives provided by the Accelerated Cost Recovery System will be an important aid to capital formation.

In contrast, REITs must distribute virtually all of their taxable income to their shareholders. Indeed, section 857(a)(1)(A) mandates that REITs must distribute at least 95 percent of such income to shareholders each year if they are to remain "qualified" as REITs for federal income tax purposes. The 95 percent distribution requirement reflects the original concept of the REIT as a form of real estate investment which would compete for capital in the financial marketplace with alternate investment forms such as partnerships.

---

[1] The Senate Finance Committee Report on the Act states, "(F)or those corporations that currently make large distributions in relation to earnings and profits, the computation of earnings and profits using the straight-line method over the generally shortened recovery periods under ACRS (Accelerated Cost Recovery System) would greatly increase the indicence of taxfree distributions. The committee bill provides therefore, the U.S. corporations will compute earnings and profits using straight-line recovery over recovery periods that are longer than the normal recovery periods used to compute recovery allowances for income tax purposes." Senate Report 97-144, 97th Congress, 1st Session (1981) at page 55. It is our understanding that the drafters did not at that time take into account entities such as REITs that are compelled to make large distributions and do not generally pay taxes.

Further, REITs, as much if not more so than manufacturing companies, are required in a competitive capital marketplace to show increasing distribution levels as one measure of business performance. Attractive growth in distribution levels greatly enhances REIT (and business corporation) ability to raise new capital. The new earnings and profits rules of the Act, however, will tend to decrease distributions net of income taxes in the hands of REIT shareholders, since the "return of capital" component in a given distribution will decrease over time as new depreciable real properties are acquired. Moreover, for newly-formed REITs, the opportunities for making any form of return of capital become almost negligible.

This result is especially unfortunate when the REIT statutory requirements and accompanying legislative history reflect an intention to create an investment vehicle that would permit small investors to obtain investment advantages otherwise available only to wealthier investors and that would provide small investors with tax incentives normally associated with direct ownership of real estate interests. Our belief that the REIT industry merits different treatment under the earnings and profits rules of section 312(k) of the Code is supported by the legislative history of the original REIT enabling legislation and the Congressional intent expressed therein.

LEGISLATIVE HISTORY OF REIT ENABLING LEGISLATION

In the Report of the Ways and Means Committee accompanying H.R. 12559 in 1960 (House Report 86-2020, 86th Congress, Second Session (1960), in discussing the reasons for passage of the REIT enabling legislation (sections 856-858 of the Internal Revenue Code), the Committee stated, at pages 3-4:

Thus, this secures for the trust beneficiaries the same type of tax treatment they would receive if they held the real estate equities and mortgages directly and, therefore, equates their treatment with that accorded investors in regulated investment companies.

Your committee believes that the equality of tax treatment between the beneficiaries of real estate investment trusts and the shareholders of regulated investment companies is desirable since in both cases the methods of investment constitute pooling arrangements whereby small investors can secure advantages normally available only to those with larger resources. These advantages include the spreading of the risk of loss by the greater diversification of investment which can be secured through the pooling arrangements; the opportunity to secure the benefits of expert investment counsel; and the means of collectively financing projects which the investors could not undertake singly.

In addition to providing equality of tax treatment between the trust beneficiaries and the investment company shareholders, your committee believes it is also desirable to remove taxation to the extent possible as a factor in determining the relative size of investments in stocks and securities on one hand, and real estate equities and mortgages on the other. This is particularly important at the present time because of the shortage of private capital and mortgage money for individual homes, apartment houses, office buildings, factories and hotels.

The advantages of investing in REITs which were enumerated in 1960 apply today. We believe that the enactment of ERTA should not alter the expectation that, within the constraints of REIT "passivity", investors should be able to engage in and benefit from real estate activities available to direct investors.

INCREASED TAX BURDEN ON REIT INVESTORS—DOUBLE TAXATION

Although section 206 of the Act causes harm to the REIT industry principally because of the dramatic shift in depreciation distribution opportunities available to REITs and partnerships, the new earnings and profits rules also serve to increase the total taxes payable by REIT investors over the amount payable under prior law.

To some extent, the increased incidence of taxation of REIT shareholders derives directly from the reduction in the possible "return of capital" component in a given distribution of REIT income. As noted previously, as a REIT expands its portfolio of property acquired subject to ERTA, the increased earnings and profits attributable to the thirty-five-year rule will ensure that a REIT making steady or expanded distributions must designate an ever increasing amount as currently taxable ordinary income.

In addition, the interaction of amended section 312(k) and the REIT tax accounting rules may cause a REIT and its shareholders to experience a form of double taxation that is clearly an anomalous result of the enactment of ERTA. The situation arises in cases in which a REIT is compelled to adopt a fifteen-year ACRS life for taxable income purposes (perhaps as the result of participation in a joint venture with parties who insist on the short useful life) while complying with section 312(k) for earnings and profits purposes. As previously illustrated, current distributions of REIT income, including distributions attributable to depreciation of the ACRS property, are taxed at ordinary income rates to the shareholder, and the REIT will accumulate little or no earnings and profits.

At the same time, the basis of property is reduced at the rate reflecting the fifteen-year life, and upon sale or other disposition of the property, the REIT or its shareholders will realize a large taxable capital gain. Because the earnings and profits basis adjustment required by the thirty-five year rule will cause less than half of that gain to be taken into account as current earnings and profits,[1] the REIT will obtain a dividends paid deduction for only that reduced portion of the realized gain regardless of the amount distributed to shareholders. Thus, the REIT will be deemed to have and must pay tax on REIT taxable income on the remaining portion of the gain. In other words, the distributions attributable to depreciation are taxed again subsequently as capital gain or as REIT taxable income. Thus, neither the REIT nor its investors receive the full benefit of the depreciation to which they are entitled under the ACRS system, and yet they are penalized further by recognition of the large gain realized on the sale of ACRS property.

REIT INDUSTRY CONCERN AND PROPOSED SOLUTION

NAREIT has received a great many inquiries from REIT industry members who are extremely concerned about this situation. A number of such members, as real estate professionals, also organize real estate organizations in limited partnership form. They are fully aware of the relative advantages and disadvantages of the two forms of organization, particularly as to the small investor. It is their belief that the changes in the earnings and profits rules contained in the Act will deal a devastating blow to REITs' ability to raise new capital in the marketplace.

We believe that the extraordinary impact which the Act will have on the formation of new REITs and the ability of existing REITs to raise additional capital in the public marketplace was unintended and obviously contrary to the Congressional intent in the original REIT enabling legislation in 1960. Furthermore, we believe that the Act should not deprive the REIT investor of the tax advantages that existed under prior law, or more importantly, should not withhold from the REIT investors the tax advantages now extended to investors that have the opportunity and the means to acquire interests in real estate directly or in partnership form.

Accordingly, we urge that Congress amend section 313(k)(3)(A) of the Code, as added by ERTA, to exclude REITs from its coverage with respect to the adjustment to earnings and profits for depreciation of ACRS property. We further urge Congress to grant this relief retroactive to the effective date of the ACRS and earnings profits provisions of ERTA. Otherwise, REITs and their shareholders will be burdened by three different sets of tax and financial accounting rules over a period of three or four taxable years, and the objectionable aspects of ERTA will be permanently applicable to property acquired subject to section 206 of the Act. Our proposed amendment (Enclosure I) would permit REITs to adjust earnings and profits to reflect depreciation on a straight-line basis under the general rule of section 312(k)(1) of the Code.

We emphasize that we seek an amendment that is effective only for 15-year real property and not other categories of recovery property, Furthermore, we do not seek the benefits of Code section 168(b)(2) accelerated cost recovery for purposes of earnings and profits, although such benefits are fully available to partnerships.

Given the relief we request, REIT investors would no longer suffer increased taxation as a result of ownership of REIT shares. Moreover, REIT investors would, to the extent possible under the limited conduit principles applicable in the REIT context, enjoy a share of the investment opportunities now available to individuals owning or holding a partnership interest in real estate. Finally, REIT's may once again enter the investment capital marketplace on a competitive footing that will enable them to prosper to the benefit of both their shareholders and the economy at large.

Sincerely,

ALLAN H. GLIDDEN, *President.*

---

[1] See Treas. Reg. section 1.312-15; B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 7.03 at 7-20 & n. 42 (4th ed. 1979).

AMENDMENT TO INTERNAL REVENUE CODE SECTION 312(K)(3) PROPOSED BY NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS, INC. ("NAREIT")

NAREIT proposes that the first paragraph of Subparagraph A of Section 312(k)(3) of the Code be amended to read as follows (amendatory language is underlined): "(A) RECOVERY PROPERTY.—Except as provided in subparagraphs (B) and (C) in the case of recovery property (within the meaning of section 168) (other than 15-year real property of real estate investment trust taxable under the provisions of Part II of subchapter M), the adjustment to earnings and profits for depreciation for any taxable year shall be the amount determined under the straight-line method (using a half a year convention in the case of property other than the 15-Year real property and without regard to salvage value) and using a recovery period determined in accordance with the following table:"

Explanation of amendment.—This amendment would permit a real estate investment trust, in computing depreciation of its real property for earnings and profits purposes, to take into account the same useful life that is employed in computing depreciation for purposes of determining taxable income.

STATEMENT OF JAMES L. POWELL, CHAIRMAN, TAX COMMITTEE, NATIONAL CATTLEMEN'S ASSOCIATION [1]

The National Cattlemen's Association (NCA) submits the following written statement for the record of the hearings on H.R. 6056, the Technical Corrections Act of 1982.

NCA commends Mr. Rostenkowski for introducing H.R. 6056, which would make technical corrections relating to the Economic Recovery Tax Act of 1981, the Crude Oil Windfall Profit Tax Act of 1980, and the Installment Sales Revision Act of 1980. NCA also commends the Congressional staffs and Treasury Department staff for a very thorough job of compiling these needed technical corrections.

NCA supports H.R. 6056; in particular, we support those provisions which:

(1) Make it clear that property which passes to a surviving spouse pursuant to a QTIP trust obtains a basis step-up at the death of the second spouse and is eligible for special use valuation in the second spouse's estate;

(2) Correct and clarify the 1981 amendments to the special use valuation rules; and

(3) Correct and clarify the 1981 amendments to the rules relating to installment payments of estate taxes.

NCA recommends that the Congress add to H.R. 6056 an additional technical amendment which would revise the holding period rules for certain property which is eligible for special valuation. For estate tax purposes and for income tax basis purposes, property purchased by a qualified heir is treated as if it had been acquired by inheritance so that the property can be specially valued and the qualified heir's basis in the property is the estate tax value of the property (even if the purchase price is higher). However, although all other property acquired by inheritance is treated as held by the estate or heir for more than one year on the date of acquisition (Code Sec. 1223(11)), this holding period rule was not extended to specially valued property purchased from an estate by a qualified heir. NCA believes that the holding period rules for other property acquired from a decedent (Code Sec. 1223(11)) should also apply to this property. This recommendation is more fully explained in the attached letter.

APRIL 8, 1982.

Re Technical problem with special use valuation of property purchased from an estate.

ROBERT J. LEONARD,
Chief Tax Counsel, Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

DEAR ROB: A technical problem with the tax rules relating to the holding period of special use valuation property purchased from an estate has come to my attention. I believe that it would be appropriate to correct this problem in the forthcoming technical corrections bill. The problem is described more fully below.

---

[1] The National Cattlemen's Association is the national spokesman for all segments of the nations's beef cattle industry—including cattle breeders, producers, and feeders. The NCA represents approximately 280,000 professional cattlemen throughout the country. Membership includes individual members as well as 51 affiliated state cattle associations and 18 affiliated national breed organizations.

BACKGROUND

Property which is acquired from, or passes from, a decedent generally has a basis equal to its estate tax value in the hands of the decedent's estate or the heirs of the decedent (IRC Sec. 1014). Also, if the basis of property is the estate tax valuation under Code Section 1014, the property is treated as having been held by the estate or heir for more than one year so that any capital gain on the sale or exchange of such property will be treated as long-term capital gain (even if it is sold within one year of the decedent's death) (Code Sec. 1223(11)).

1981 ACT

The Economic Recovery Tax Act of 1981 ("ERTA") provides that "property acquired from a decedent" includes property that is purchased from a decedent's estate by a qualified heir so that such property would be eligible for current use valuation (Code Sec. 2032(e)(9)(E) as amended by ERTA Sec. 421(j)(2)). If the property is specially valued, a qualified heir who purchases the property must use the current use value of the property as his income tax basis even if the purchase price exceeds (or is less than) the use value.

For estate tax purposes and for income tax basis purposes, property purchased from an estate by a qualified heir is treated as if it had been acquired by inheritance. However, for holding period purposes, the property is not treated as acquired by inheritance.

REASONS FOR CHANGE

Consistency with the estate tax and the income tax basis rules would appear to require that the property acquired by purchase from the decedent's estate by a qualified heir be treated as acquired by inheritance for purposes of the holding period rules.

Under rate circumstances, a portion of the basis might exceed the current use value because the purchase price exceeds the fair market value of the property and the estate would recognize a gain on the property. However, the acquisition by purchase of property from an estate by a qualified heir is essentially a testamentary disposition because this form of disposition is often adopted by an individual who has one substantial asset—the farm or ranch—and wishes to leave it to the "on-farm" heir but to treat his "off-farm" heirs essentially equally from a financial point of view. Thus, the fact that, in rare instances, a gain may result to the estate should not be a reason to treat the property as "purchased" for holding period purposes, just as it is not a sufficient reason to treat such an acquisition as a purchase for estate tax purposes and income tax basis purposes.

PROPOSED AMENDMENT

The amendment would provide that property which is purchased by a qualified heir from a decedent's estate is treated as acquired from the decedent for purposes of the holding period rules (just as it is for purposes of the income tax basis rules and the special valuation rules).

This amendment should have the same effective date as Section 421(j)(2) of ERTA.

This amendment would affect relatively few situations. It would only have any effect if the qualified heir were to resell the property when his holding period, without taking the decedent's holding period into account, were less than one year. Also, since the heir could "tack" the estate's holding period (Code Sec. 1223(2)), the heir would normally be required to sell the property within one year of the decedent's death to be adversely affected by present law. Also, since a sale to a person other than a family member would trigger the recapture tax and a basis set-up to fair market value as of the date of death of the decedent could be obtained at a relatively minor interest cost, the only situations which would be adversely affected by present law would involve sales to family members.

Although the problem with present law would affect relatively few situations, failure to treat property purchased by a qualified heir as acquired from a decedent for holding period purposes is a trap for the unwary and does not appear to have been intended by Congress. Consequently, this proposed amendment should be included in the technical corrections bill.

If you have any questions on this matter, please contact me.

Sincerely,

ALVIN J. GESKE.

STATEMENT OF THE NATIONAL COMMITTEE FOR ADOPTION

The National Committee For Adoption is a national voluntary group made up of agencies and individuals who support adoption. We endorse the concept of allowing adoption expenses to be considered a deductible item on individual tax returns and therefore were pleased that the Economic Recovery Tax Act of 1981 took the first step toward that goal. The first step—the inclusion of a deduction up to $1,500 for those families who adopt a child with "special needs"—found in Section 125 is a very important and useful provision of the tax law. However, we have been concerned by the seemingly unintentional limitations of the provision. These limitations will be improved by the technical change suggested in H.R. 6056.

The first limitation which concerned us was addressed in the "General Explanation of the Economic Recovery Tax Act of 1981" published by the Joint Committee on Taxation. The way Section 125 is now worded, it implies that adoption assistance payments funded by Section 473 of the Social Security Act must be accepted and received by a family in order to be eligible for taking a deduction for expenses incurred in the adoption process. This implication resulted as a perverse effect in our opinion—providing a deduction only to a class of taxpayers who are already beneficiaries of government funded adoption assistance payments. The "General Explanation" does clarify this by saying: "A refusal of adoption assistance payments by an individual to whom such payments are made available will not preclude the deduction." (See page 57.)

What is still left uncertain is whether the true intent of the Congress was to limit the tax deduction to children who are "put through" the eligibility determination process for Social Security Act adoption assistance payments. This then excludes children who meet the descriptive requirements of "child with special needs" found in Section 473(c)(1) and (2) of the Social Security Act. The National Committee For Adoption urges the Congress to adopt the technical amendment in H.R. 6505 which would make clear that children with the "special needs" characteristics—but whose adoptive families do not wish to be made eligible and do not wish to accept government adoption assistance payments—will still be eligible to deduct the adoption expenses incurred from their income taxes.

The experience of several of our members has not been positive with regard to the current implications of Section 125 of the Economic Recovery Tax Act. There are often times children that voluntary, not-for-profit adoption agencies have responsibility for, who meet the description of a "special needs" child, who are not the wards of the State, and who are in need of permanent, adoptive homes. These children are not automatically "put through" the eligibility procedures for State/Federal government adoption assistance payments. Several of our member agencies have placed children with special needs with families without depending upon government eligibility or adoption assistance payments. Unfortunately, they could not recommend to the adoptive parents the utilization of the tax deduction. A technical amendment will alleviate this problem.

In summary, what is currently happening is that adoptive couples who work exclusively with voluntary, not-for-profit adoption agencies are not eligible for the tax deduction unless they "exploit" the State's eligibility determination process just to be determined eligible for adoption assistance payments—even though they have no intentions of accepting the adoption assistance benefit. By amending the current provision in Section 125, it will result in less expense for the process of providing a permanent adoptive home to a child with special needs who might otherwise become a ward of the State and dependent upon governmental funds for care.

The National Committee For Adoption has been working for the enactment of adoption expenses tax deduction legislation since the 96th Congress. We endorse, H.R. 1596 and H.R. 4158, sponsored by Congressman Oberstar and co-sponsored by several members of the Ways and Means Committee, which will allow families who adopt healthy infants and children from other countries to also deduct their expenses from their taxes. We look forward to working with this Committee in considering this bill as well as the improvements being recommended for the current tax law provision for the deduction of adoption expenses for a child with special needs.

WASHINGTON, D.C., *April 30, 1982*

Re Statement of Shriners Hospitals for Crippled Children re Technical Corrections Act

JOHN J. SALMON,
Chief Counsel, Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

DEAR MR. SALMON: This statement is submitted on behalf of the Shriners Hospitals for Crippled Children pursuant to the Committee's Press Release of April 19, 1982.

I. BACKGROUND—THE WORK OF THE SHRINERS HOSPITALS

The Shriners Hospitals for Crippled Children is a tax exempt charitable organization which was founded in 1922. It operates 21 hospitals in cities across the United States, with a total of about 1,000 beds. The purpose of this charity is to furnish free hospital care to children. The hospitals specialize in treating children with severe burn injuries and with orthopedic problems.

Each of the Shriners hospitals furnishes top-quality medical care to children at absolutely no cost to the parents of the children or to third parties. The hospitals receive no reimbursement, either from any level of government or from health insurance carriers. Last year, the hospitals treated 17,331 orthopedic inpatients and outpatients at an average cost of $4,792 per child, and 1363 inpatients with burns at an average cost of $10,925 per child. The Shriners' Hospitals' operating budget is over $69 million per year, and capital projects in progress are estimated to run over $110 million in the next few years.

II. SHRINERS HOSPITALS DEPEND COMPLETELY ON CHARITABLE DONATIONS TO FUND THEIR CHARITABLE WORKS

All of these capital and operating costs of the Shriners Hospitals are funded completely by contributions from the general public. Indeed, many people who become familiar with the vital work of the Shriners Hospitals choose to donate a substantial portion of their assets through trust and testamentary charitable contributions. Their gifts are the financial lifeblood of the children's medical care furnished by the Hospitals.

The interest of the Shriners Hospitals in the Technical Corrections Act stems from this total dependence on such charitable contributions. A large proportion of the support of the Shriners Hospitals is in the form of large gifts which are part of the estate plans of wealthy individuals. The Shriner Hospitals thus have a great interest in the provisions of ERTA which permit coordination of marital and charitable deductions in estate plans. We are particularly interested in Section 403 of ERTA, insofar as it was intended to allow a marital deduction for the full amount of a qualifying split-interest gift passing to the decedent's spouse, and a charitable deduction for the full amount of the qualifying split-interest gift passing to a charity.

III. SPECIFIC RECOMMENDATIONS

1. ERTA Section 403 added a new I.R.C. Section 2056(b)(8)(A) to the Internal Revenue Code. It provides that, in the case of a "qualified charitable remainder trust," the marital deduction shall be allowed for "any interest in such trust which passes or has passed from the decedent to such surviving spouse." The added I.R.C. Section 2056(b)(8)(B) defines a "qualified charitable remainder trust" as a "charitable remainder annuity trust or charitable remainder unitrust (described in section 664)."

We see no reason to limit the coverage of I.R.C. Section 2056(b)(8) to annuity trusts and unitrusts, and not also include pooled income funds. When the provisions of I.R.C. Section 664 relating to annuity trusts and unitrusts were first proposed in 1969, the House originally limited charitable deductions for split interest gifts to these two forms of charitable remainder trusts. H. Rep. No. 91-413, (Part 1), 91st Cong., 1st Sess. 58. However, the Senate modified these provisions so that charitable deductions were allowed for the portion of split-interest gifts passing to charities in the form of pooled income funds. S. Rep. No. 91-413, 91st Cong., 1st Sess. 479-482 were allowed. The provisions of the Senate bill were eventually incorporated into the statute. H. Conf. Rep. No. 91-782, 91st Cong., 1st Sess. 296-297.

Various provisions of the Internal Revenue Code group these three types of split-interest trusts together for purposes of qualifying for various charitable deductions. Thus I.R.C. Section 170(f)(2) allows an income tax deduction for a gift of a remainder interest in trust only if "the trust is a charitable remainder annuity trust or a charitable remainder unitrust * * * or a pooled income fund * * *." Section 2055(e)(2) allows an estate tax charitable deduction for a remainder interest passing to a charity, where the income interest passes to a noncharity, if "such interest is in a trust which is a charitable remainder annuity trust or a charitable remainder unitrust * * * or a pooled income fund * * *." A virtually identical provision is contained in I.R.C. Section 2055(c)(2) for gift tax charitable deductions.

The fact that pooled income funds have always been treated as charitable remainder trusts, like annuity trusts and unitrusts, is also demonstrated by the various amendments to the I.R.C. Section 2055(e)(2) estate tax charitable deduction. These provisions have allowed decedents' estates to reform wills to comply with the charitable remainder rules set forth in the Tax Reform Act of 1969. The reformation provisions have always been applied to pooled income funds, as well as annuity trusts and unitrusts. See, e.g., P.L. 93-483, 88 Stat. 1457, Sec. 3(a); temporary Estate Tax Regulations under Section 3 of the Act of the October 26, 1974, Sec. 24.1(a)(2) (26 C.F.R.).

Indeed, pooled income funds are so frequently grouped with annuity trusts and unitrusts that the omission of pooled income funds in new Section 2055(b)(8) could be interpreted by the courts as deliberate. It is true that it might be possible to obtain marital and charitable deductions for a contribution to a pooled income fund, with one's spouse as income beneficiary, by use of I.R.C. Section 2055(b)(7). See General Explanation of the Economic Recovery Act of 1981, 97th Cong., 1st Sess. 238, fn. 5 (Dec. 31, 1981). However, allowance of the combined deduction is not certain under Section 2055(b)(7), since the courts might hold that Section 2056(b)(8) is the more explicit provision dealing with split interest gifts of remainders, and the failure to include deductions, for pooled income funds under that provision precluded allowing deductions for gifts to pooled income funds under Section 2056(b)(7). Cf. *HCSC-Laundry* v. *United States*, 101 S. Ct. 836, 838–839 (U.S. 1981).

Moreover, a marital deduction under I.R.C. Section 2056(b)(7) for the income interest in a pooled income fund could be deemed to be precluded by Section 104(a)(8) of H.R. 6056, the proposed Technical Corrections Act of 1982. That provision would amend I.R.C. Section 2056(b)(7)(B)(ii) by adding the sentence, "An annuity shall not be treated as a qualifying income interest for life" for purposes of interests which qualify for the marital deduction under that statute. While the statute does not define the term "annuity," the plain and ordinary meaning of that term could be broad enough to cover life interests in pooled income funds, as well as annuity trusts and unitrusts. If this were true, marital deductions for life interests in pooled income funds would seem to be precluded by the proposed clarification of I.R.C. Section 2056(b)(7), and by the omission of pooled income funds from I.R.C. Section 2056(b)(8).

There is no reasonable basis for this adverse treatment of pooled income funds. Such funds are frequently used by taxpayers whose assets are not large enough to justify a separate unitrust or annuity trust. There is no reason for discriminating against this tax planning tool used by persons with more moderate incomes who desire to give to charity.

Accordingly, we request that I.R.C. Section 2056(b)(8)(B)(ii) be clarified as follows: "(ii) Qualified Terminable Trust.—The term 'qualified charitable remainder trust' means a charitable remainder annuity trust, or charitable remainder unitrust (described in section 664), or a pooled income fund (described in section 642(c)(5))."

Furthermore, we also suggest that the legislative history of H.R. 6056 make clear that the added sentence in I.R.C. Section 2056(b)(7)(B)(ii) excluding annuities from qualified income interest status is not intended to exclude annuity trusts and unitrusts described in I.R.C. Section 664, and pooled income funds described in I.R.C. Section 642(c)(5).

Please let us know if you have any questions regarding these matters.

Sincerely yours,

William J. Lehrfeld, P.C.
By: Leonard J. Henzke, Jr.

Southland Royalty Co.,
Fort Worth, Tex., April 28, 1982.

Mr. John J. Salmon,
Chief Counsel, Committee on Ways and Means,
Longworth House Office Building, Washington, D.C.

Gentlemen: Southland Royalty Company, an independent oil and gas producer located in Fort Worth, Texas, would like to submit the following comments for your consideration in finalizing the Technical Correction Act (H.R. 6056) as it pertains to the Windfall Profits Tax (WPT). While we have no objections to most of the Technical Amendments, there are several which Southland believes are very controversial and beyond the scope of a Technical Amendments Bill.

DEFINITION OF "CRUDE OIL" SUBJECT TO WINDFALL PROFITS TAX

H.R. 6056 would amend the definition of "crude oil" to include "condensates recoverable from natural gas (whether or not recovered before the natural gas is removed from the premises)." We believe a definition tied to a "recovery concept" is unworkable, unduly burdensome, contrary to many gas contracts and will unfairly increase the "WPT" on oil and gas producers. Southland Royalty believes a more workable definition of taxable crude oil would include "condensate from associated and non-associated gas production recovered by or on behalf of the producer through mechanical separation whether located at the lease, at central field facilities or at inlet side of a gas processing plant".

Condensate can be extracted at many different places depending upon the arrangement of production and processing facilities, weather, equipment performance, and contract requirements. In many cases condensate is recovered from natural gas after title to the gas and any components it contains has passed from the producer to the gas purchaser. An excerpt from one of our recent gas contracts reads as follows: "upon delivery, title to the gas and all components thereof shall pass to and vest in Buyer without regard to the purpose for which it may thereafter be sold or used by Buyer." The price provisions of this same contract provide "as full consideration for the gas and all components thereof . . . Buyer shall pay Seller a price determined as follows: Seller's base price per McF for gas in each pricing category as defined in the Natural Gas Policy Act of 1978 ("NGPA") shall be eighty-five percent (85 percent) of such base price . . .". The current price for this gas is $2.26/McF or $13.10 on a crude oil equivalent barrel basis.

It is very likely under the above contract that condensate is extracted from our gas stream after title passes to the Buyer. Southland, however, has been paid a price tied to the NGPA and receives no additional compensation for any condensate or other liquids ultimately extracted. Clearly, in such a situation no "WPT" liability should arise for Southland even though condensate may ultimately be extracted from the gas stream.

The point is each gas contract is unique and may provide for full compensation, partial compensation, or no compensation for condensate ultimately extracted. Because the "WPT" is only levied against the producer of crude oil, a "recovery concept" for taxable condensate would create a tax on value never received by the producer in many situations.

Southland Royalty has no objection to the taxation of condensate when the producer has full title to liquids. If Congress believes condensate, regardless of where recovered and who has title, is subject to the "WPT" then the tax must be expanded to include gas pipeline companies and gas plant owners who have title to condensates recovered downstream of the gas delivery point.

We would also point out, there is no present industry measuring and accounting system in place to determine recoverable condensate at the point of sale or delivery from the producer to the gas buyer. If the producer is to be held liable for "WPT" on all condensate ultimately recoverable from his gas, major and dramatic changes in the oil industry's measurement and accounting procedures will be required. It is our opinion that an attempt to apply a "recovery concept" would prove unworkable and unenforceable.

The proposed definition of "crude oil" in H.R. 6056 appears to be more substantive than technical and imposes unintended consequences on the petroleum industry and administrative and enforcement problems upon The Treasury Department.

ALLOCATION OF PRODUCTION TO NET PROFITS INTEREST

H.R. 6056 also proposes to allocate, only for "WPT" purposes, to the net profits interest owner a pro rata share of the crude oil used to meet production costs. This proposal is actually a substantive change rather than a technical correction.

The proposal would allocate the production necessary to cover the costs deducted in calculating the net profits amount to the net profits owner. The result is that a proportionally higher percent of the production is allocated to the net profits owner which may change the amount of windfall tax due based upon the producer's status.

This treatment is directly contrary to the handling of production of a net profits owner for Federal income tax purposes and appears to be solely an effort to reflect a greater portion of the "WPT" to the net profits owner. A net profits interest is a royalty interest. The fact that certain costs are deducted in calculating the royalty is irrelevant to apportioning production and "WPT". Once the royalty is calculated, then the amount of production necessary to pay the royalty is attributed to the net profits interest owner. There is no merit in allocating production to cover the costs used in calculating the net profit amount ([illegible] royalty) to the net profits owner, solely for windfall profits tax purposes.

ALLOCATION WHERE PRODUCTION EXCEEDS INDEPENDENT PRODUCER AMOUNT

In H.R. 6056 the windfall profits tax is amended to provide that only an independent producer's qualified production is considered when allocating the independent producer amount. We concur in this amendment, however, we believe one last step is needed.

Under current rules when an independent producer allocates within a tier the allocation is based on the highest removal price. While this language was undoubtedly intended to benefit the independent producer (i.e. higher priced barrels should have the highest windfall profit and would most benefit from a reduced rate) in practice that goal is somewhat frustrated. In some instances the barrels with the largest windfall profit will not have the highest price (remember windfall profit is sales price less base price). In other instances the highest priced barrels may be income limited and pay little or no tax anyway. As a result, the benefit of the lower independent producer tax rates of the lower independent producer tax rates can be largely lost.

We would encourage the deletion of 150.4992(c)(2)(B). In this manner a producer could allocate the independent producer amount as he chooses between qualified barrels within tier 1 and tier 2.

Sincerely,

MICHAEL L. SCHAUWECKER,
Manager, Regulatory Compliance.

VALERO ENERGY CORP.,
San Antonio, Tex., April 23, 1982.

Hon. DAN ROSTENKOWSKI,
Chairman, Committee on Ways and Means, Longworth House Office Building, Washington, D.C.

DEAR SIR: Valero's pipeline systems are in the business of buying, selling and transporting natural gas in both the intrastate and interstate markets. Operations are conducted through a network of some 8,100 miles of gas pipelines, compressor stations, and gas treatment facilities, all located in Texas. Gas enters the Valero pipeline systems through small gathering lines that are connected to more than 9,000 gas producing wells. Valero also buys gas from other pipelines.

Producers will typically remove condensate which is in suspension in the produced gas by mechanical separation on the lease or in the vicinity of the wells prior to the entry of the gas into Valero's pipeline system (lease/field condensate). After the gas has entered the Valero system from various producers, gathering companies, and other pipeline companies, due to changes in temperature and pressure, additional condensate is separated from this comingled stream of gas at the inlet to compressor stations, extraction plants, treating plants, dehydration or sales points. For lack of a better term, we will refer to this condensate as pipeline drip.

Under current law, taxable crude oil is defined by refenence to the June 1979 energy regulations. Sec. 201 of H.R. 6056 under consideration by your committee would add to that reference the following new sentence: "Such term includes condensates recoverable from natural gas (whether or not recovered before the natural gas is removed from the premises)."

The crude oil windfall profit tax is imposed upon the producer—the owner of an economic interest in the crude oil in place in the ground. Generally the first purchaser of crude oil is responsible for collecting and paying over the tax. If the crude oil is removed from the premises prior to sale, the burden is then upon the producer to report and pay the tax.

There are numerous problems associated with a definition of crude oil which includes pipeline drip condensate as taxable crude oil. The condensate is separated not as a part of the mining or producing process, but as an incidental but necessary part of the pipeline transportation process. Clearly, the pipeline company which separates and sells this material is not the producer and not subject to tax. The pipeline company cannot identify how much condensate was separated from each of the various sources of gas which make up the comingled transportation stream. The gas from which the drip is separated was purchased at a controlled price, and there should be no windfall profit associated with it. If the tax were somehow imposed upon the producer, there would be regulatory problems in that many gas purchase contracts would call for a reimbursement of that tax to the producer, and the pipeline company would then have to include this cost in its rates charged to its customers. The consumer would wind up paying a tax on a hypothetical windfall which did not exist in fact.

There are problems with the present definition of crude oil which need to be resolved, however, the amendment would exacerbate these problems rather than solve them.

We recommend that this amendment be stricken from the technical corrections bill and that the taxable status of condensate be studied carefully and taken up later in a more appropriate manner.

Very truly yours,

James A. Walker,
Manager, Tax Planning & Research.

Winstead, McGuire, Sechrest & Minick,
Dallas, Tex., May 1, 1982.

Hon. Dan Rostenkowski,
Chairman, House Ways and Means Committee,
Washington, D.C.

Dear Congressman Rostenkowski: As the Chairman of the House Ways and Means Committee you currently have under consideration the Technical Corrections Bill of 1982 (H.R. 6065). As a part of this Bill, certain technical corrections are being made in Section 2023A of the Internal Revenue Code which deals with farm valuation. These corrections are found in Section 421 of H.R. 6056.

In addition to those changes in the Bill, I would like to bring to your attention one related area of Section 2023A which, in my opinion, has been totally misinterpreted by the Internal Revenue Service and, therefore, needs technical correction to the language used.

Many parcels of real property used for farm and timber land are owned by multiple owners having undivided interests in the land. Sometimes these co-tenants are related and sometimes they are not. Only the decedent's interest in the land is valued in a Federal Estate Tax Return but, irrespective of this, the Internal Revenue Service has interpreted Section 2023A(d)(2) as meaning that all persons having undivided interests in the land irrespective of whether they are beneficiaries of the Estate or will benefit in any manner from the special valuation must consent in a written agreement to the election for special use valuation. Once they have consented, the Internal Revenue Service takes the position that the lien under the Internal Revenue Code Section 632B applies to all of the land and not to just the undivided interest valued in the Estate. At no other place in the Internal Revenue Code does the Code or the Internal Revenue Service take the position that their lien covers property other than property being valued for tax purposes. A comparable situation would be the special lien for estate tax deferred under section 6166 or 6166A but the lien (as provided for in Internal Revenue Code Section 632A) correctly covers only the land valued in Estate.

It appears quite clear from an overall reading of the provisions dealing with the farm valuation that Congress intended that the lien cover the interest of the Estate and not the interest of co-tenants who are not beneficiaries of the Estate.

I would strongly recommend that while you are in the process of considering H.R. 6056 that you amend Section 2032A(d)(2) to change the existing language which reads: "(2) Agreement.—The agreement referred to in this paragraph is a written agreement signed by each person in being who has an interest (whether or not in possession) in any property designated in such agreement consenting to the application of subsection (c) with respect to such property."

So that it reads as follows: "(2) Agreement.—The agreement referred to in this paragraph is a written agreement signed by each person in being who has an interest (whether or not in possession) in any property valued in the Estate consenting to the application of subsection (c) with respect to such property."

We respectfully request that you consider this change. I have found in my practice that more than half of the Estates that would have benefited from the election of the farm valuation have had that valuation denied by the Internal Revenue Service on the basis of co-tenants refusing to consent.

Attached is a copy of an Internal Revenue Letter Ruling that evidences this problem.

Thank you for your consideration.
Yours very truly,

RICHARD G. HAMON.

Enclosure.

[¶ 12,446G] IRS Letter Ruling 8145028, August 7, 1981.

[CODE SEC. 2032A]

Estate tax—Valuation—Farm and closely held business property—Election—Amendment.—An estate that elected special use valuation for a decedent's undivided interest in a farm could not amend the legal description of the property set forth in the notice of election because the co-tenants did not sign the agreement to special use valuation required under the regulations. The only interest that was eligible for special use valuation was the undivided interest that the decedent owned at his death. Back reference: ¶ 6458.028.

ISSUE

Whether the failure of the co-tenants to sign the original agreement required under section 2032(a)(1)(B) and (d)(2) for special use valuation of the decedent's undivided ⅓ interest in farm property that the decedent owned in co-tenancy with his brothers at the time of his death precludes an amendment to the notice of election to change the legal description of the specially valued property from an undivided ⅓ interest in the whole to a 100 percent interest in ⅓ of the property.

FACTS

At the time of this death the decedent owned an undivided ⅓ interest as tenant in common with his two brothers in 678 acres of farm property.

The federal estate tax return was timely filed. The executrix elected special use valuation for the decedent's interest in the farm property. The agreement required by section 2032A(1)(B) and (d)(2) was signed by the surviving spouse and her children. The co-tenants, however, did not sign the agreement and have refused to sign any agreement consenting to application of section 2032(A)(c).

Under an agreement concluded in 1981 the exectrix and the co-tenants have agreed to partition the property so that each co-tenant will own a 100 percent interest in 226 acres (⅓ of 678).

The executrix proposes to amend the notice of election of special use valuation to change the description of the specially valued property from an undivided ⅓ interest in the 678 acres to full ownership in the 226 acres.

LAW

Section 2032A provides that the executor may elect to value real property used for farming based on the property's value as a farm rather than its fair market value. Section 2032A(a) provides as follows:

(a) Value Based on Use Under Which Property Qualifies.—

(1) General Rules.—If—

(A) the decedent was (at the time of his death) a citizen or resident of the United States, and

(B) the executor elects the application of this section and files the agreement referred to in subsection (d)(2) then, for purposes of this chapter, the value of qualified real property shall be its value for the use under which it qualifies, under subsection (b), as qualified real property.

Section 2032(d) provides for the election and agreement as follows:

(d) Election; Agreement.—

(1) Election.—The election under this section shall be made not later than the time prescribed by section 6075(a) for filing the return of tax imposed by section 2001 (including extensions thereof), and shall be made in such manner as the Secretary shall by regulations prescribe.

(2) Agreement.—The agreement referred to in this paragraph is a written agreement signed by each person in being who has an interest (whether or not in possession) in any property designated in such agreement consenting to the application of subsection (c) with respect to such property.

Section 2032A(b)(1)(D) requires that the specially valued property be designated in the agreement referred to in subsection (d)(2).

Section 20.2032A-8 of the Estate Tax Regulations discusses the election and agreement and provides that once made, the election is irrevocable. Subparagraph (a)(3) of this section provides for the time and manner of making the election. The election is made by attaching to the return the agreement required by section 2032A (a)(1)(B) and (d)(2) and a notice of election containing certain required information. The information required to be submitted includes the following:

(iii) The items of real property shown on the estate tax return to be specially valued pursuant to the election * * *

* * * * * * * *

(xii) The name, address, taxpayer identification number, and relationship to the decedent of each person taking an interest in each item of specially valued property, and the value of the property interests passing to each such person based on both fair market value and qualified use.

(xiv) A legal description of the specially valued property.

Paragraph (c) of section 20.2032A-8 sets forth the requirements of the agreement required by section 2032A(a)(1)(B) and (d)(2) as follows:

(c) Agreement to special valuation by persons with an interest in property—(1) In general. The agreement required under section 2032A(a)(1)(B) and (d)(2) must be executed by all parties who have any interest in the property being valued based on its qualified use as of the date of the decedent's death. . . . In the case of parties (other than qualified heirs) with interests in the property, the agreement must express consent to collection of any additional estate tax imposed under section 2032A(c) from the qualified property.

(2) Persons having an interest in designated property. An interest in property is an interest which, as of the date of the decedent's death, can be asserted under applicable local law so as to affect the disposition of the specially valued property by the estate. Any person in being at the death of the decedent who has any such interest in the property . . . must enter into the agreement. Included among such persons are . . . co-tenants, joint tenants and holders of other undivided interests when the decedent held only a joint or undivided interest in the property or when only an undivided interest is specially valued. . . .

ANALYSIS

The decedent's interest in the farm property at the time of his death was an undivided ⅓ interest in the full 678 acres. It was not until a time more than a year after the decedent's death that the farm was divided among the decedent's estate and the other co-tenants so that each of the three now owns a 100 percent interest in 226 acres.

The property that may be specially valued is the property that the decedent owned at the time of his death. The agreement required by section 2032A(a)(1)(B) and (d)(2) must be executed by all parties who have any interest in the property being valued based on its qualified use as of the date of the decedent's death. Here the co-tenants had an equal undivided ⅓ interest in the farm at the date of the decedent's death. Regulations section 20.2032A-8(c)(2) requires any person having an interest in the property to enter into the agreement and specifically mentions co-tenants as being included in the group of those having an interest who are required to sign the agreement.

CONCLUSION

The failure of the co-tenants to sign the agreement required for special use valuation of the decedent's undivided ⅓ interest in farm property that the decedent owned at the time of his death precludes an amendment to the notice of election to change the legal description of the property from an undivided ⅓ interest in the whole to a 100 percent interest in ⅓ of the property.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

○